International business reorganisations: tax neutrality and the preservation of Chilean taxing rights under Law 21,713

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Introduction

Law 21,713, which has recently been enacted and is currently in force, introduces significant amendments to the general rules governing tax neutral business reorganisations.

Within the Chilean legal system, these rules fall under the authority granted to the Chilean Internal Revenue Service (Servicio de Impuestos Internos or SII) to assess the values used in taxable transactions. Pursuant to this power, the SII may reasonably adjust the values or prices of transactions when they significantly deviate from normal market values in order to determine tax effects.

In this context, Article 64 of the Chilean Tax Code (Código Tributario or CTC) provides specific exceptions according to which, subject to certain requirements, the SII is inhibited from exercising its appraisal powers. This enables the transfer of assets during the course of a business reorganisation at values different from the market value, and prevents the SII from reassessing such values for the purpose of determining taxable capital gains.

This article focuses on asset contributions within the framework of international business reorganisations. Prior to the enactment of Law 21,713, cross-border asset contributions could fall under the reorganisation rules. However, the relevant requirements were not expressly set forth in the law and their application largely depended on their interpretation by the SII, which by its nature is subject to administrative changes.

Under the new legal framework, the following conditions must be met for an asset transfer carried out as part of an international business reorganisation (other than a merger or spin-off) to qualify as tax neutral:

- the transaction must have an impact on assets, shares or rights located in Chile;
- a legitimate business purpose must exist;
- no cash flows may arise for the contributor;
- the tax cost of the transferred, assigned or contributed assets must be preserved in the context of the reorganisation;
- compliance with the legal requirements in the relevant foreign jurisdiction is required; and
- the reorganisation must not impair Chile's taxing rights, in other words, any subsequent contribution or transfer of the assets initially assigned or contributed as part of the reorganisation must remain effectively subject to taxation in Chile.

This article will primarily address requirement number one, number two and number six, as we believe their interpretation may involve the highest degree of legal scrutiny during review processes and raise questions regarding their proper fulfilment.

The exhaustion and production of effects in Chile

Prior to the legislative amendment, the CTC did not expressly refer to international reorganisations or to the possibility of such reorganisations being considered tax-neutral. In light of this legislative gap, the SII interpreted that a neutrality regime could apply to these transactions, provided that the tax effects were 'produced and exhausted in Chile.' This concept gradually developed through administrative rulings, which identified two distinct interpretative approaches:

Formalistic approach

This was the first approach adopted by the SII. It involved a case-by-case analysis based on the residence or location of the contributors, recipients and the contributed asset, to determine whether an international reorganisation could qualify as tax neutral.

The most representative example of this approach involved a foreign contributor transferring a Chilean asset to a foreign recipient. The SII consistently interpreted such a transaction as one in which the tax effects were 'not produced and exhausted in Chile'. Although this conclusion was not extensively elaborated on, it may be understood that, because neither the contributor nor the recipient was required to have accounting records in Chile, and the SII lacked the means to verify whether the asset's tax cost remained unchanged, its control and traceability was hindered from a tax perspective.

Substantive approach

Subsequently, the SII adopted a more substantive criterion, assigning specific content to the phrase that 'the tax effects are produced and exhausted in Chile'.

This approach was first introduced in Ruling No 2213/2022, in which the SII explained that for a transaction to 'exhaust its tax effects in Chile', any capital gain derived from a future sale of the contributed assets must be subject to taxation in Chile.

In this sense, it appears that the SII considered certain international reorganisations eligible for the exception to its valuation authority, provided that the subsequent sale of the contributed assets would be taxed in Chile. Logically, and in order to preserve Chile's taxing rights, it was understood according to tax practice that the subsequent taxation should occur under the same conditions as would have applied had the asset been transferred before the reorganisation.

The current status of international reorganisations

Law 21,713 has now expressly regulated the transfer of assets in the context of international reorganisations, effectively incorporating certain principles previously developed through the SII's administrative jurisprudence, as explained below:

- the preservation of Chile's taxing rights: this requirement was defined by establishing that Chile's taxing rights are preserved when any subsequent contribution or transfer of the assets that were assigned or contributed during the reorganisation are effectively subject to taxation in Chile. In this way, the legislative text formally adopts the administrative principle that the tax effects must be exhausted in Chile in a direct and unambiguous manner; and
- the production of effects on assets, shares or rights located in Chile: this requirement appears, in our view, to derive from the distinction made by the SII in Ruling No 2213/2022 between effects being 'produced' and 'exhausted' in Chile. We believe that while the concept of 'exhaustion' is now reflected in the requirement concerning the preservation of taxing rights, the notion of the 'production of effects' corresponds to this second element.

Unlike the first requirement, the second aspect lacks elaboration in administrative interpretations, substantive legislative discussion or a specific regulatory definition. The legislative history merely includes an isolated recommendation suggesting that it should be sufficient for the transaction to produce tax effects in Chile (whether in relation to persons or transactions), without requiring the contributed asset to be physically located in the country.

Unresolved issues/pending challenges

Notwithstanding that Law 21,713 aimed to simplify and clarify the requirements for the application of the reorganisation rules, several questions remain from an international perspective, as discussed below.

Effects on shares, assets or rights located in Chile

A key question is whether the provision refers exclusively to transactions involving assets located in Chile or rather aims to exclude international reorganisations without any real connection to Chile. Under a strict reading, certain structures, such as those involving Chilean parties and foreign assets, could fall outside the scope of the rule and become subject to valuation. However, we believe this requirement should be understood as a filter designed to exclude reorganisations lacking a real connection to Chile. The rationale is as follows:

- during the legislative process, specific recommendations were made to clarify this requirement, suggesting that the reference to 'assets located in Chile' should be removed and replaced with broader language referring to tax effects in Chile, such as on persons or transactions domiciled in the country. That these suggestions were not incorporated implies the legislature considered the existing language sufficiently clear. In other words, it is not necessary for the contributed asset to be physically located in Chile, but only that the transaction produce a real tax impact in the country;
- Law 21,713 substantially reflects the criteria developed by the SII at the administrative level. At no point did this interpretation require the contributed asset to be located in Chile in order to apply the exception to valuation. Rather, the focus was on preserving Chile's taxing rights in the event of future disposals; and
- the law's core objective was to provide certainty and facilitate the application of the international reorganisation rules. A formalistic or territorial reading would contradict this objective and create uncertainty and arbitrary exclusions.

How Chile's taxing rights must be preserved

The wording of Article 64 of the CTC and the legislative background indicate that Chile's taxing rights are deemed preserved so long as a subsequent contribution or transfer of the assets remains subject to taxation in Chile. This would generally be the case if:

- the contributed asset is located in Chile or generates Chilean-source income (Articles 10 and 11 of the Income Tax Law); or
- the recipient of the contribution is domiciled in Chile or otherwise ensures that future disposals or contributions will be taxable according to the worldwide income principle.

However, it is not entirely clear whether the future taxation must always fall on the recipient entity or if it may also apply to a foreign shareholder who indirectly holds an interest in a Chilean asset. For example, a reorganisation might result in the loss of taxing rights if, in regard to a future 'indirect transfer' (eg, the sale of a foreign entity owning Chilean subsidiaries), Chile is unable to tax the capital gain.

Even so, both the literal interpretation and the underlying purpose of the provision suggest that the requirement is met as long as a future direct sale of the asset would be taxable in Chile.

Likewise, in the reverse scenario, where a Chilean taxpayer contributes a foreign asset to a foreign entity, the loss of taxing rights is not necessarily absolute. If the recipient entity is controlled from Chile, and the asset generates passive income or income accrued in Chile, such income may still be subject to Chilean taxation.

Assessing whether Chile's taxing rights are affected may involve complex considerations regarding timing, mechanisms and the corporate level at which such rights are impacted.

From a substantive perspective, it may be helpful to record within the corporate documentation of the reorganisation that the tax treatment of Chilean assets remains unchanged and that any potential future disposition would remain taxable in Chile at any level. This could serve as a strong argument in support of applying the tax-neutral regime to the transaction.

That said, while a purely substantive approach may appear to enable a broad range of reorganisations in theory, it is essential to recall that the purpose of the rule is to preserve Chile's taxing rights, and to allow and regulate international business reorganisations with a focus on preventing the erosion of Chilean taxing rights.

On the other hand, the legitimate business purpose requirement serves as a substance-over-form safeguard, empowering the SII to challenge reorganisations that are solely motivated by tax considerations, particularly where the sole purpose is to avoid taxation.

A legitimate business purpose has been a longstanding requirement of the reorganisation rule, but until Law 21,713, it lacked a legal definition and was addressed only in abstract terms by the Chilean SII. The new law defines it as any purpose aimed at improving business conditions, such as obtaining financing, mitigating risks or increasing efficiency, as long as it is not exclusively tax driven.

Key takeaways

Law 21,713 expressly regulates international tax-neutral reorganisations. The legal requirements established are consistent with the historic interpretation upheld by the SII.

The international reorganisation rule is aimed at preserving Chile's taxing rights in the context of cross-border reorganisations. The guiding principle is that the future disposal of an asset must remain subject to taxation in Chile.

Many cases appear straightforward, such as reorganisations involving assets located in Chile or where the recipient is a Chilean taxpayer.

However, there are cases where Chile's taxing rights may not be immediately affected or only potentially affected in the future, which will likely require further legal developments and interpretations. In our view, the substantive test embedded in the legitimate business purpose requirement serves as a safeguard against an overly restrictive interpretation of the rule.