Equity or debt govern tax highlights of foreign investment

Juan Pablo Navarrete and Manuel José Garcés of Carey y Cía explain that depending on whether it is through equity or debt, an investment in Chile has particular tax implications.

In the early 21st century, Chile has become one of the favourite destinations for foreign investors in Latin America. This is because of the seriousness with which Chile has performed both in economic policy and international relations, promoted by legislation that encourages the entry of foreign capital to develop local and regional projects.

Means of investment

The traditional starting point for any foreign investment project is to determine whether the funding should be through a capital contribution or through debt. From a tax perspective there are considerable differences between each option, which certainly would be a key factor when deciding how to finance a specific project in Chile.

Capital contribution financing

Financing an investment in Chile through a capital contribution has the benefit that no tax would be triggered at the moment of funding the Chilean vehicle and/or in keeping the investment in the country, except for an annual municipal licence that applies over the local entity's tax equity (capped at approximately $660,000).

Two regimes exist for entry of a foreign investment into Chile. The less bureaucratic manner of remitting funds into Chile is by the rules contained in Chapter XIV of the Compendium of Foreign Exchange Regulations of the Central Bank. This regime requires the foreign investor to register the amount to be brought into Chile with no obligation to convert the foreign currency into Chilean pesos. Additionally, no minimum term for investment is required for capital repatriation.

The second regime is provided by the Foreign Investment Statute, Decree Law No 600 of 1974. This legislation is a mechanism for transferring capital to Chile, where foreign investors importing capital or physical assets, or making other forms of investment, have to sign a foreign investment contract with the State of Chile.

Investors who transfer funds and enter into a foreign investment contract with the State of Chile will benefit from this status, one of the greatest benefits of the contract being the tax stability clause that is available.

Being a contract, this clause provides, independently for the reforms or changes that could be made in the tax legislation during the project, that the contract would be subject to a fixed standard rate of 42% as the total tax burden to be borne by the investor. The tax stability clause may be waived by the investor at any time, but may not be restored to the prior conditions if such an election is taken.

The main disadvantages of Decree Law 600 are that the investor would be required to convert their foreign currency into Chilean pesos; and the process of repatriation of the invested capital could be done one year after the investment was made.

Returning to the financing analysis through a capital contribution and already understanding how this process could be carried out by the foreign investor, it is important to consider the capital repatriation process when the investment has been made through equity.

To reduce the capital of a Chilean entity, specific imputation rules need to be taken into account. As a general consideration, from a tax standpoint, capital reductions are treated as tax-free income for the shareholder that is reducing its interest in a specific legal entity. However, to be treated as tax-free income, the capital-reduced entity should not have registered taxable or book profits in its ledgers. If the entity has registered taxable or book profits, the amount remitted abroad would be treated as a taxable profit distribution up to an amount equivalent to the registered taxable and book profits. In the latter case, in addition to the corporate tax already paid by the local entity for this profit, a second-level tax would be triggered to the shareholder when the remittance is made, in the case of foreign investors, is a 35% withholding tax (having the corporate tax paid by the local entity as credit).

Therefore, any proceeds remitted from a local entity to its foreign shareholder would be imputed first to taxable or financial profits, capitalised or not, and then the remaining remittance would be considered as a proper tax-free capital reduction.

Debt financing

Another option for financing foreign investment projects is through entering into a debt relationship with a foreign lender. This method involves the existence of a loan granted by a foreign investor to a Chilean company, by which it injects resources directly to the Chilean vehicle. It is important to take into consideration that by the mere act of entering into a debt-claim relationship with a local entity, a stamp tax – 0.05% per month with a cap of 0.6% applicable over the principal amount – would be triggered in Chile.

Even for the immediate tax effect that a loan could trigger in Chile, this option has important advantages for the foreign investor compared with an equity contribution.

First of all, foreign investors would be able to repatriate the principal amount at any time, regardless of the situation of the taxable or books profits registered in the Chilean entity. Thus, there is complete freedom of disposal of the funds invested in the country and the timing for when they could be repatriated to the investor. It is important to point out that any principal payment made abroad would be tax-free and no withholding tax would be applicable in Chile.

Regarding the withholding tax applicable on interest payments related to the debt-claim relationship created between the foreign investor and the local company, different situations should be considered.

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General rule

Interest payments made abroad are generally subject to a 35% withholding tax. Interest payments could be deducted from the taxable income of the local entity if they satisfy the general requirements of taxable expenses.

Special 4% regime

Interest payments to satisfy a loan granted by a foreign bank, a foreign financial institution or a foreign insurance company (that fulfills special investment requirements) are subject to a reduced withholding tax rate of 4%. A thin-capitalisation ratio of 3:1 enters into play if the Chilean borrower is related to the lender or is deemed to be related (as occurs in back-to-back structures).

Special tax treaties regime

Generally, article 11 of most of Chile's tax treaties comprises a reduced withholding tax rate applicable to interest payments made to a beneficial owner that is a resident of the corresponding state.

Comparison between funding methods

As was noted in the earlier analysis, a foreign investment made through an equity contribution would trigger practically no tax effects at the moment of the funds entering Chile or during the period of the investment. Even so, the imputation rules applicable to potential capital repatriations could be a substantial fact to take into consideration when structuring a business project in Chile.

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On the other hand, financing through a loan would trigger at the starting-point a stamp tax calculated over the amount of the principal. After this tax consequence, the foreign investor would be able to handle their investment with total autonomy of the local entity's business results. Finally, a potential reduced withholding tax rate on interest payments could be a key reason to prefer a loan funding structure.

Methods of liquidating the investment

Once the options for financing a foreign investment in Chile are analysed, it is important to look at the options for liquidating an investment and the tax effects each could entail.

In general terms, the foreign investor would need to choose whether to sell directly the local vehicle created to perform the project or to do it indirectly through the sale of the foreign holding vehicle that has the interest of the Chilean entity.

Direct sale of the Chilean company

If the intention is to transfer the interest of the Chilean company, different regimes of capital gain taxation exist depending on whether the local entity is a limited liability company (*Sociedad de Responsabilidad Limitada*) or a corporation (*Sociedad Anónima* or *Sociedad por Acciones*). In the first case, a capital gain from the sale of equity rights would be always subject to a general tax regime, (that is, corporate tax and withholding tax, where the corporate tax is used as a credit for determining the tax payable, leaving a final tax burden of 35%). Meanwhile, in the case of a sale of shares of corporations, a capital gain may be subject to the general tax regime or to a special tax regime, where corporate tax applies as a sole tax (a final tax burden of 18.5%). To be eligible for the special tax regime on the sale of stock, the foreign investor would need to meet these requirements: selling the stock at least one year after its acquisition; selling to a non-related party; and not being an habitual stock trader.

Additionally, there is full tax-exemption for capital gains derived from the sale of regularly-traded shares in listed stock corporations if certain requirements are met.

It is important to bear in mind that a tax reform bill (Tax Reform) filed on August 2 2012 is pending in the Chilean Congress. The Tax Reform involves a modification of the regimes described above, introducing a standardisation of the treatment applicable to capital gains, where the disposal of equity rights in a limited liability company could be subject to the special solely corporate tax regime available only for the sale of stock in a corporation (it also envisages increasing the corporate tax rate to 20%).

Indirect transfer rules

If the intention is to dispose of the foreign holding entity that has the interest of the Chilean company, it would be necessary to analyse the current limited scope of the Chilean indirect transfer rules that regulate the sale of foreign entities with underlying assets in Chile.

The Tax Reform aims to improve these indirect transfer rules on determining the source of income from foreign operations that involve underlying assets in Chile.

Here is an explanation of the regime and the main guidelines that can be deduced from the drafting of the Tax Reform that might be incorporated if the law is finally enacted.

Current law

The legislation states that income derived from the sale of shares or equity rights of a foreign company is considered as Chilean source income if, in general terms:

- the acquirer is domiciled or resident in Chile;
- the acquisition causes, directly or indirectly, that the buyer acquires interests of a company incorporated in Chile, and
- the interest acquired represents more than 10% of the capital or profits of the Chilean company.

In this sense, though the foreign investor intends to sell its participation in a foreign holding entity which in turn is the owner of a Chilean company, a Chilean source taxable capital gain would be triggered if the requirements described above are met in the transaction.

Under the law, the disposal of the foreign holding entity would have no tax effect if the acquirer is a non-resident alien. This situation constitutes a loophole in the Chilean tax legislation that has been constantly used to transfer participation of Chilean entities.

Main guidelines of the Tax Reform regarding indirect transfer rules

The Tax Reform proposes to extend the scope of what should be considered as a Chilean source income when a sale of a foreign entity with Chilean underlying assets occurs. Under the potential new indirect transfer rules, not only the income derived from the disposal of shares or social rights in a foreign company would be taxed in Chile, but the generation of income derived from the sale of almost any value that could constitute an interest in a foreign company, such as bonds or securities convertibles into shares or rights, with Chilean underlying assets involved, would also be a taxable event.

Additionally, the requirement for the acquirer to be a Chilean resident or domiciled is removed, closing definitively the loophole explained above. Moreover, it would not be necessary to test the 10% percentage of acquisition of the Chilean entity to determine whether the income is Chilean-sourced, but rather what should be tested in an initial situation is:

- if the Chilean underlying assets represents at least the 20% of the fair market value of the interest that is being sold of the foreign holding entity; and
- if the interest of the foreign holding company that is being transferred corresponds at least to the 10% of such entity.

If the first situation is not met, the indirect transfer rules would be also applicable:

- if fair market value of the Chilean underlying assets is higher than about $200 million; and
- if the interest of the foreign holding company that is being transferred corresponds at least to the 10% of such entity.

Finally, the indirect transfer rules would be also applicable if the transferred entity is a resident of a jurisdiction considered as a tax haven by the Chilean Treasury Department.

Therefore, the draft Tax Reform states that the income generated in the sale of a foreign holding company with underlying assets in Chile would not be subject to taxation in Chile, if the transaction does not fall under any of the three situations. On the other hand, if a transaction meets any of these situations, a Chilean taxable capital gain is triggered.

Considering the above analysis, taxpayers and their advisers should check the tax regime applicable to the transfer of Chilean assets through the disposal of foreign entities to decide the most efficient liquidating process. If the Tax Reform is enacted as it is drafted, special consideration should be taken of foreign entities that hold Chilean investments through entities incorporated in jurisdictions listed in Chile as tax havens.

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