THE CHILEAN TAX REFORM

Introduction

Following is an overview of the main components of the tax reform bill of interest to foreign investors. The Chilean Tax Authority ("SII") has yet to clarify a number of doubts that have arisen regarding how certain aspects of the tax reform should be applied in specific cases. The main decision as regards which regime to choose should be made by the end of 2016, so there is still time for analysis.

I. Income Tax

A. Increase in Corporate Income Tax

First category corporate income tax will progressively increase from 20% to either 25% or 27% (depending on the type of regime) as follows:

Year 2014: 21%
Year 2015: 22.5%
Year 2016: 24%
Year 2017: The new taxation regimes discussed below will apply
- Fully integrated regime: 25%
- Partially integrated regime: 25.5%

Year 2018: 27% (only applicable in the case of the partially integrated regime)

B. New Taxation Regimes

As of January 01, 2017, the law creates two alternative corporate income tax regimes (first category tax):

i) **Fully integrated regime** (Article 14 A of the Income Tax Law ("ITL")) under which foreign shareholders will be subject to the additional tax (withholding tax on profit remittances abroad) on the income from their ownership held in companies in the same year in which the income is recognized, and

ii) **Partially integrated regime** (Article 14 B of the ITL) where foreign owners will be subject to the additional tax only on the profit effectively distributed by the company. Each taxpayer will select one regime, taking into account the formalities established in the law. **The selection should be made by the last quarter of 2016**. If the taxpayer does not actively select a regime, the law provides for a default rule as follows:

i) The fully integrated regime will be applied to:
individual entrepreneurs
individual limited liability companies
limited liability companies where the owners are only Chilean individuals

ii) The partially integrated regime will be applied to:
limited liability companies where one or more owners are legal entities or taxpayers not

resident or domiciled in Chile
taxpayers under the regime established in Article 58 No. 1 (permanent establishments)
stock companies (SAs and SpAs) Once the applicable regime is determined, by choice or by default, a five-year holding period is required.

i) Fully integrated regime

Under this regime, the company will be subject to first category income tax at a 25% rate on its annual taxable income. In addition, the same year the company shall attribute this income to the final owners that are subject to additional tax (foreign residents) or personal income tax ("global complementario", in the case of individuals resident in Chile). The owners will pay the relevant tax and have the right to use the first category tax paid by the company that generated the profit as a credit.

This means taxpayers subject to additional tax or personal income tax will be taxed on the income of the companies in which they have an interest in the year this income is recognized, with the corresponding direct tax credit, *regardless of whether or not any profit distributions are actually made*.

For the nonresident taxpayers under the additional tax regime, this regime results in a total tax burden of 35% applied to the year the company generates profits (25% paid by the Chilean company and 10% by the owner abroad).

The attribution of income to be made by a company, as explained above, is made regardless of the number of companies in a chain of ownership and regardless of the taxation regime selected by each of the other companies in the ownership chain. Therefore, a subsidiary subject to the fully integrated regime must attribute the income it derived to its owners that have the status of final taxpayers, regardless if the other investment companies or holdings in the chain of ownership are subject to a different regime.

As an exception, attribution of income will not reach local individual or foreign owners if a company in the chain of ownership is in a loss position. In these cases, losses will absorb the fully integrated profits, thereby giving the company in a loss position the right to request a refund for the amount of the first category tax paid by the company attributing the income.

For effective distributions from a company under the fully integrated regime, distributed profits will be subject to the following attribution order:

a) Fully integrated income already taxed: no taxes are imposed
b) Exempt income: no taxes apply
c) Retained taxable earnings associated with income generated up until the end of 2016: in this case the former (current) taxation regime will apply
d) Excess distributions from prior items (e.g., temporary differences) will be affected by the 35% additional tax with first category tax credit, if any.

ii) Partially integrated regime

Companies under this regime will be subject to a first category corporate income tax at a 25.5% rate in 2017 and 27% as of 2018. At the same time, foreign and local individual owners will only pay the relevant tax on effective profit distributions and will be allowed to use as credit the first category tax paid by the distributing company, with certain limitations.

This regime is similar to the current taxation regime that operates under the Retained Taxable Earnings Ledger ("FUT") as in both cases owners subject to the additional tax will only be taxed on effective dividend distributions. However, under the new partially integrated regime, the taxpayers will only be able to access as credit an amount equivalent to 65% of the corporate income tax paid by the company.

The foregoing translates to a total taxation of 44.45% on distributed income.

Important consideration for foreign investors:

Much of the language used in foreign investment contracts (DL 600) and other communication targeting foreign investors in Chile has typically been focused on assuring foreign investors that they will be treated on equal terms as local investors. Ironically, with the tax reform, foreign investors domiciled in a country with which Chile has a ratified Convention to Avoid Double Taxation ("Tax Treaty"), will receive *preferential* treatment compared to local investors. Under the terms of the standard OECD model Tax Treaty, in the event taxpayers that are domiciled in a Tax Treaty country are subject to the additional tax, total taxation should remain at 35% even with the partially integrated regime.

In this way, these foreign investors can essentially:

1. continue to postpone the additional tax levied at the moment of profit distribution,
2. continue to pay the total tax of 35% on distributed profits with the first category tax applied as a full credit, and
3. enjoy preferential tax treatment compared to those investors domiciled in Chile.

In order to determine the taxes applicable to each effective dividend distribution, the attribution order according to this regime is as follows:

a) Income subject to final taxes (additional tax or personal income tax), in which case the additional tax will apply as well as the appropriate credit. This income is the difference between the equity (the higher between book and tax) and the exempt income and less the share capital adjusted by inflation (therefore, it includes book profits in excess of tax), whichever is higher
b) Exempt income: no taxes would apply
c) Retained taxable earnings (FUT) for income generated before January 01, 2017, in which case the former taxation regime applies.

In summary, ignoring for a moment the benefit enjoyed by investors domiciled in Tax Treaty countries, company owners can essentially choose between paying all of their tax each year (fully-integrated regime) or postponing a portion of their total tax burden, but ultimately paying a higher rate (partially integrated regime).

iii) Additional considerations regarding taxation regimes

a) Tax losses

As of 2017, only loss carryforward will be available and loss carryback will no longer exist. Up until now, it has been possible for a company that generates taxable income and pays tax on this income in year 1, which then suffers a loss in year 2, to claim back a portion of the income tax paid in year 1 to compensate for the year 2 loss ("PPUA"). This will no longer be possible. However, the right to offset losses at the level of a holding company to dividends distributed by subsidiaries (with the corresponding right to obtain a refund) will still be available.

b) Reorganizations

Tax-free reorganization rules remain unchanged, and conversions, mergers and demergers are still permitted without triggering taxable events; however, the company that is converted, created or absorbed should be under the same regime before the reorganization until it completes the mandatory five-year period. If a company is subject to the partially integrated regime and the same is dissolved or merged into an entity subject to the fully integrated regime, a 35% tax on accumulated profits will apply.

II. Capital Gains Tax

The first category tax regime as a sole tax applicable to capital gains derived from the sale of shares or social rights is eliminated as of January 01, 2017. Therefore, the sale of shares or quotas in a Chilean company performed by foreign residents will, as a general rule, be subject to a total tax burden of 35%, unless a special tax regime applies, i.e., exemption or no taxation (for example, shares acquired before 1984 or listed shares) or sales under special rules contained in a Tax Treaty.

In addition, if capital gains apply to indirect transfers, the capital gains can be charged to the Chilean subsidiary that is transferred. On the other hand, interests related to investment in local companies will be deductible, regardless of the type of entity.

III. International Tax Rules

A. Excess indebtedness rules

New excess indebtedness rules are introduced, as well as amendments to the existing rules in connection with the following matters:

The 3:1 debt-to-equity ratio remains unchanged; however, in order to determine the amount of debt, all loans granted by local or foreign entities, whether related or not, shall be included. Up until now, only loans granted by foreign related parties subject to 4% withholding tax on the interest were included.

The 35% penalty tax only applies to payments to related entities subject to the 4% withholding tax or not subject to withholding taxes.

The concept of "related company" now applies to all kinds of guarantees granted by the group companies.

These new rules will apply only to loans granted as of **January 01, 2015**.

B. Preferential tax regimes

The concept of a preferential tax regime has been established by the law to enhance the current list of tax havens. This classification means that royalty, technical service and interest payments are deemed made to a related party and the foreign entity is deemed to be a controlled entity.

According to the new provisions, any jurisdiction where at least two of the following assumptions exist will be considered a preferential tax regime:

- The effective tax rate on foreign source income is below 17.5%
- No convention for the exchange of information for tax purposes has been executed
- Legal systems are not based on OECD or UN guidelines on transfer pricing
- The jurisdiction imposes legal limitations on its tax authorities that prevent them from requesting information and/ or using and disclosing such information to foreign countries
- The jurisdiction's laws and regulations are considered as preferential regimes for tax purposes by the OECD and the UN
- The jurisdiction imposes taxes under a territorial system

Note: Notwithstanding the foregoing, country members of the OECD will not be considered preferential tax regimes.

IV. Additional Considerations

A. Rejected expenses

The regime applicable to non-deductible (rejected) expenses remains unchanged; however, the penalty tax rate increases from 35% to 40%.

B. Deduction of intra group remittances abroad

A new requirement has been introduced for the deduction of service-related expenses, royalties, interest, freight, insurance, leases and all types of income contemplated in Article 59 of the Income Tax Law paid to foreign related parties as follows:

- The applicable withholding tax should have been declared and paid, if appropriate
- The remittance of funds abroad should have been effectively made

C. Goodwill

Up until the end of 2014, goodwill has been treated as an amortizable asset. Effective January 01, 2015, goodwill arising out of a merger will be deemed a non-amortizable intangible.

D. Stamp tax

The stamp tax rate will double as of January 01, 2016, as follows:

- The monthly rate will increase from 0.033% to 0.066% and the maximum rate will increase from 0.4% to 0.8% (for loans of terms with one year or more).
- The rate applicable on documents issued on demand or with no specified maturity date will increase from 0.1666% to 0.332% (equivalent to the rate applied for five months).

E. Value added tax

As of January 01, 2016, the assumptions used to apply the value added tax will now also cover the customary sale of immovable property.

F. General anti-avoidance rules

In 2015 new substance-over-form rules will become effective. These new rules give the SII the authority to challenge a transaction due to abuse or simulation and to request payment of the relevant taxes that would have applied. The tax courts may rule on the existence of abuse or simulation in a given situation; however, the burden of proof is on the SII. These anti-abuse rules apply to transactions carried out after the entry into force of the substance-over-form rules; therefore, all prior transactions will be subject to the rules currently in force.

V. Special Transitory Regimes

A. Capital repatriation rules

A capital repatriation regime is established only for 2015 according to which Chilean taxpayers will be able to make a statement to report all such foreign assets or profits that had been acquired before January 01, 2014. Once the statement is filed, an 8% sole tax will apply on the total amount reported.

B. 32% sole tax on FUT

The tax reform gives companies the right to pay a 32% tax on their accumulated retained taxable earnings (FUT) and use as credit the first category income tax paid on these retained earnings. This option applies to those companies that initiated operations before 2013, that have accumulated FUT as of December 31, 2014, and the tax must be levied against the portion of the retained earning balance in excess of the average annual amount of the total withdrawals, remittances or distributions annually made by the company owners over the last three years.