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Global Tax Alert

News from Americas Tax Center

Chile proposes tax reform

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On 23 August 2018, the Chilean Executive Power proposed a tax reform bill, which encompasses several high-complexity tax rules.

Given the complexity of the bill, we have created a landing page dedicated to the tax reform bill, which can be found on our website at www.eychile.cl. The landing page includes detailed explanations and summaries of each of the modifications. The landing page will be updated as the bill is changed in Congress.

Fully-integrated tax system

New single integrated system and simplification of registries

The bill would repeal current Section 14, which includes "attributed" and "semi-integrated" regimes, and establish a single system with full integration (i.e., 100% of corporate taxes would be recognized as a tax credit by shareholders). A second level of taxation would apply only upon an effective distribution of profits to foreign shareholders or Chilean individual shareholders.

The bill also would simplify and redefine the corporate tax registries (RAI, REX DDAN and SAC, as per their acronyms in Spanish). If companies do not keep a registry for exempt income during a calendar year, the bill would waive the requirement to keep registries, unless capital distributions take place and no tax profits are left.

Profit allocation order

The bill would modify the profit allocation order for dividends. If a dividend distribution exceeds accumulated tax profits, the bill would allow the dividend distribution to be allocated to capital, provided it is formally treated as a capital distribution in February of the following year, at the latest.

Corporate tax credit calculation rules

The bill would reformulate the corporate tax credit calculation rules as follows:

- ▶ An average factor would be determined, which would result from dividing the SAC registry tax credits (excluding tax credits arising from taxes paid abroad) by net profits that have not been levied with final taxes (which equals the sum of the balances of the RAI and DDAN registries, before dividend distributions minus outstanding corporate taxes).
- ▶ The average factor would apply to dividends and would be allocated to the SAC registry.
- ▶ The average factor would be capped at the result of the corporate tax rate (25% or 27%, depending on the size of the business) divided by 100, minus said rate.
- ▶ A special provision would be established to assign tax credits, resulting from taxes paid abroad, to dividend distributions.

The bill would allow a company to generate a corporate tax credit for its shareholders, even if no tax credit were allocated to them, because the SAC registry does not have enough balance.

Improperly determined taxable income or tax credit

The bill would establish rules to adjust taxable income or tax credits that were wrongfully determined. As a general principle, if a shareholder is assigned less tax credit than it should have received, the bill would not require the shareholder to adjust its tax return; rather, it would require the source company to adjust its own records and returns.

Reporting obligations

The bill would require companies to report the following items annually:

- ▶ Amount of the calendar year's profit distributions, identification of beneficiaries, type of income (i.e., taxable or exempt) and the tax credit factor used
- ▶ Items recorded in the registry that need to be carried forward

- ▶ Calculation details of the RAI registry and tax equity (*Capital Propio Tributario*), along with the amount of the financial equity
- ▶ Amount of depreciation differences recorded in the DDAN registry, determined for each asset

Corporate reorganizations

The bill would establish additional rules for the tax effects of corporate reorganizations (spin-offs, mergers, entity conversions). Under the bill, the following rules would be established for spin-offs, mergers and entity conversions:

- ▶ **Spin-off ("división"):** Assignment of tax registry balances would be based on tax equity assignment (except for accelerated depreciation adjustments, which follow the respective asset); however, the bill would allow taxpayers to apply for authorization to have tax registry assignment based on financial equity.
- ▶ **Merger and entity conversion:** The surviving entity would keep the registries of the absorbed/converted entity and taxation under Section 38 bis (liquidations) would not apply; mergers and conversions between companies with full accounting would be regulated separately from those that record their operations differently.

Digital tax

The bill would establish a 10% tax rate on digital services provided by nonresidents to Chilean individuals (independent of where servers may be located). The tax would apply to digital brokering services, digital content entertainment (either downloadable, streaming or other technology), advertising services (to be used abroad), use of and subscription to platform and technological services and storage services (cloud or software services).

The bill would establish electronic payment administrators (e.g., credit card companies) as withholding agents. The bill would require the Chilean Internal Revenue Service (IRS) to keep a list of both digital service providers and withholding agents.

Expense deductibility

The bill would define an "allowed expense" as an expense that is directly or indirectly connected to the development of the taxpayer's business, including expenses that are ordinary, extraordinary, customary, exceptional, voluntary or mandatory (the concept of "necessity to produce taxable income" would be eliminated). The expense also would have to:

- ▶ Be reasonable, depending on the circumstances
- ▶ Not have been deducted as a cost
- ▶ Be paid or owed during the tax year
- ▶ Have a legal cause and not come from unlawful behavior or schemes
- ▶ Be reliably proven before the IRS

The bill would modify the deductibility rules to allow accounts receivable, or a percentage thereof, to be written off after 365 days. The IRS would determine the percentage to be written off, based on industry uncollectable debt indicators. The bill would exclude debt with related entities (i.e., nondeductible) from these rules.

The bill also would:

- ▶ Remove the shareholder wage cap,¹ but would require the wage to be “reasonably proportionate”
- ▶ Eliminate the 4% royalty deduction cap
- ▶ Allow expenses from environmental permits and settlements to be deductible
- ▶ Allow expenses related to compensating clients, if ordered by regulatory agencies, to be deductible
- ▶ Treat payments made in a settlement or as a result of contractual penalties as expenses
- ▶ Allow payments made to a shareholder’s spouse
- ▶ Establish methodologies for allocating expenses connected to the generation of taxable and non-taxable income

Depreciation

The bill would establish “semi-instantaneous depreciation” to allow taxpayers with an average income of less than 100,000 UF (approx. US\$4,115,000) for the last three years to depreciate assets by taking into account 1/10 of the useful life set for tax purposes.

The bill also would establish “transitory instantaneous depreciation” under which taxpayers would be allowed to instantaneously depreciate 50% of their investment in fixed assets made within 24 months of the bill becoming law.

For the Araucania region, the bill would allow “transitory instantaneous depreciation” in the amount of 100% of the fixed asset investment.

Capital gains

The bill would allow IGC² taxpayers to choose to pay a “sole tax”³ at a 20% rate on capital gains or apply general rules.

The bill also would modify the rules for capital gains on real estate, mining concessions, water rights, bonds and debt instruments. It would no longer treat the transfer of financial instruments made under a buyback agreement as a “transfer” for tax purposes. The difference between the “spot purchase” and the “hire purchase” would be considered an expense for the seller and income for the buyer.

In addition, the bill would not treat short-selling as a transfer. Taxes would apply to the accrued or realized income of both parties.

The bill would not impose a tax on the granting of stock options under an employment contract or collective agreement, or their exercise. The owner of the stock options would only be subject to taxes on the capital gains, resulting from the transfer of the option or the asset.

The granting of the stock options in a compensation arrangement outside of an employment contract would not be taxable. However, the bill would treat the exercise of the stock options as remuneration.

The bill also would establish a new residual rule under which capital gains, resulting from the transfer of any other assets, would be treated under the same rules as stock.

The bill would not allow the current benefits⁴ consisting of exempt capital gains (under 10 UTA, approx. US\$8,700), and IGC reliquidation to apply if the transfer of property is made to related parties. Only the 20% “sole tax” would apply in this case.

Tax credit for taxes paid abroad

The bill modifies the tax credit rules for taxes paid abroad. The bill would broaden the types of income to which the tax credit could be applied, regardless of the existence of a double taxation agreement with the source country from which the income originates.

Withholding taxes and corporate taxes of the paying entity and its subsidiaries would be creditable, even if the subsidiaries are resident in a third country - but only if the latter has an information exchange or double taxation

agreement with Chile. When a Chilean entity holds another Chilean entity through a nonresident vehicle, any Chilean taxes paid would be creditable.

The bill would establish a new method for calculating the foreign tax credit. The new method would include the new concept of “taxable income of foreign source” and new caps (individual and global) on the tax credit.

Chilean-source income derived from export services and levied abroad would be entitled to a tax credit if the taxpayer’s average annual income for the last three years is below 100,000 UF.

Withholding rules

The bill would modify the withholding rules, set forth in Section 74 No. 4 of the Chilean Income Tax Law, to establish rules for when a reduced or zero withholding tax applies as a result of a double taxation agreement.

Project finance

Under the bill, the thin capitalization rules would not apply if funding corresponds to the development, enhancement or improvement of one or more projects in Chile, and is provided, in most part, by unrelated parties that demanded to allocate debt in foreign entities.

Preferential tax regimes (tax havens)

The bill would simplify the rules for determining when a territory or jurisdiction may be labeled as a “preferential regime.” Such label would apply only if the effective tax rate of such territory or jurisdiction is below 30%, unless an information exchange agreement with Chile is in place.

Business termination

The bill would modify the business termination rules by adding special rules for small and medium-sized businesses (PYMEs for their Spanish acronym). Additionally, when a business terminates, the bill would allow shareholders to pay the IGC, instead of the 35% exit tax.

The bill would eliminate the 35% tax rate applicable to the liquidation of an entity with corporate shareholders.

Provisional Monthly Payments (PPM)

The bill would allow taxpayers that undergo a change in income, costs or expenses during the year to request a reduced PPM rate.

PYMEs

Corporate tax rate and PYME requirements

The bill would establish a corporate tax rate of 25%, with 100% of the corporate taxes paid recognized as a tax credit by shareholders. A second level of taxation would apply only upon an effective distribution of profits to foreign shareholders or Chilean individual shareholders.

Currently, PYMEs must apply to be included in the PYME regime. The bill would revise the requirements for the PYME regime and would automatically include PYMEs in the regime if those requirements are met. To qualify as a PYME, the bill would require a business to have:

- ▶ Average gross or accrued income of 50,000 UF (approx. US\$2,060,000) or less for the last three years, including related entity and person income and excluding the income of shareholders or financing parties that have the purpose of promoting investment in technological innovation (requires CORFO^y certification); such average must be maintained while belonging to the regime
- ▶ Tax equity of 60,000 UF (approx. US\$2,500,000) or less if the taxpayer just entered into business
- ▶ At least 65% of its gross income not be passive income (real estate, except agriculture, financial instruments, holding companies, etc.)

The bill would require shareholders to pay taxes only upon profit distributions, with 100% integration (i.e., full corporate tax credit).

The bill would require PYMEs to keep a full accounting, without an inflation adjustment. PYMEs also would have to record unsold or unused inventory as an expense during the respective year.

The bill would not require PYMEs to keep the DDAN registry, which means shareholders may benefit from accelerated depreciation. The bill also would allow PYMEs to choose to acknowledge income and expenses on a cash basis (as opposed to accrual basis).

IRS tax return proposal

The bill would allow PYMEs and their shareholders to opt to pay taxes based on a tax return proposal made by the IRS, provided their annual income is lower than 10,000 UF (approx. US\$410,000), and they belong to certain industry sectors as defined by the Chilean IRS. The IRS’s proposal would be based on industry margins. The bill would provide

rules on how those industry margins would be calculated. The IRS would have to publish the industry margins in advance so taxpayers could choose whether to use the IRS's proposal. The IRS's tax return proposal also would be based on the tax information available to it, which could be accepted or modified by the taxpayer.

The bill would allow PYMEs to make PPM of 0.25%, instead of the variable rate calculated on the previous year's gross income.

Reinvestment

The bill would continue the 2014 reinvestment benefit, but would reformulate it. Under the reformulated reinvestment benefit, PYMEs could deduct up to 50% of their taxable base, if the taxable base remains reinvested in the company. The PYME would not have to apply adjustments in the following years.

Tax transparency option

The bill would allow shareholders to choose to be taxed immediately, with final taxes on their underlying PYME results. To qualify for this option, PYMEs would have to have a full accounting and annual gross income below 50,000 UF. Additionally, all of the shareholders would have to be individuals.

Transparent PYMEs would be allowed to make PPM of 0.25%.

Other income tax modifications

The bill would differentiate between the concept of "legal domicile" and the concept of "residence."

Value added tax (VAT)

The bill would modify the VAT rules to prohibit taxpayers from mixing taxable and non-taxable services. The bill would require the IRS to conduct an analysis of each service the taxpayer provides.

The VAT refund procedure would be modified in general, so that the IRS would have to respond to the refund request within five days, unless a "special prior audit" (FEP) were triggered under certain circumstances (which must last no longer than 30 days). If the VAT refund claim were for VAT paid on export services, the IRS would have 25 days to respond.

Additionally, the bill would shorten the timeframe to obtain VAT refunds on fixed asset acquisitions.

The bill would also create a special VAT regime for small merchants. Under the new regime, taxpayers whose average annual sales for three years are below 2,400 UF (approx. US\$100,000) could pay VAT based on a gross margin on net acquisitions. The IRS would establish such margins.

Inheritance and gift tax

The bill would clarify that the definition of gift is the definition provided in the Civil Code. The bill would establish rules for gifts made abroad that are subject to Chilean tax.

The bill would establish a tax exemption for inheritances when the spouse of a deceased individual also passes and the inheritance tax was previously paid when the first spouse died.

Gifts made with funds that have already been subject to full income taxation (both corporate and personal, including non-taxable income) would be exempt from gift taxes, with an annual cap of 500 UTM (approx. US\$36,000). To calculate the cap, taxpayers would have to take into account gifts made to heirs for up to 10 years.

The bill would allow taxpayers to apply for a three-year extension to pay inheritance and gift taxes, but interest would not be forgiven.

Audit rules and taxpayer rights (Tax Code)

The bill would establish:

- ▶ An administrative appeal before a higher authority as part of the RAV⁶ procedure
- ▶ New rules for general administrative requests, including a maximum term of 60 days for the IRS to resolve these requests
- ▶ A new administrative complaints procedure
- ▶ A simplified procedure to apply for electronic documents issuance
- ▶ A new affirmative silence rule⁷
- ▶ New definitions for resident and related party

The bill also would revise the taxpayer rights catalogue and would include the following rights:

- ▶ Right to have the IRS Director set mandatory timeframes for all IRS procedures lacking a timeframe

- ▶ Right to have foreign documents or evidence be admitted during an audit, without having to meet additional requirements
- ▶ Right to not have the same facts, accounts, evidence or legal criteria reviewed a second time after they have already been part of an audit, even for different years
- ▶ Right to privacy and personal data protection during an audit
- ▶ Right to be unencumbered or unhindered in the normal course of business as a result of an audit, unless so stated by the law
- ▶ Right to a good faith assumption by the IRS

Additionally, the bill would restrict the IRS's ability to audit and request documents that were created after the statute of limitations. With few exceptions, the restriction would apply to the carryforward of losses, VAT credit balance and "tax equity composition."

If the IRS modified any legal interpretation or criterion improving the taxpayer's position, the bill would require the change to be applied retroactively, even when tax refunds are triggered.

The bill would require audits to have a maximum duration of 9, 12 or 18 months, depending on the matter being audited.

The bill would eliminate the discovery rules⁸ applicable to an IRS systems audit and would establish as a general principle that taxpayers may not be hindered from operating in the normal course of business because of the IRS system audit.

In addition, the bill would overhaul the appraisal powers set forth in Section 64 of the Tax Code and would establish the following rules:

- ▶ Grounds for appraisal
- ▶ Asset valuation rules
- ▶ Evidence rules and legal presumptions favoring the taxpayer depending on the type of operation or asset transferred (e.g., a sale price is deemed arm's length if made to an unrelated party)
- ▶ Special rules on domestic and international corporate reorganizations

Appraisal powers would not apply to mergers, spin-offs and capital increases (in certain cases). The bill also would repeal the "legitimate business reason" for capital contributions.

Taxpayer's Defense Agency (DEDECON)

The bill would create a taxpayer's defense agency that would observe and protect taxpayers' rights. The DEDECON would have the following powers:

- ▶ Watch for the protection of taxpayer legal and constitutional rights
- ▶ Receive administrative complaints taxpayers may file against IRS officers and intervene in the administrative procedure
- ▶ Propose to the IRS non-binding measures to protect taxpayer rights
- ▶ Issue non-binding public recommendations concerning IRS acts or behavior that may infringe taxpayer rights or tax law
- ▶ Initiate investigative actions to assess infringements of taxpayer rights
- ▶ Denounce facts that may give rise to administrative liability by IRS officers
- ▶ Intervene as a third party in mediation procedures between the IRS and taxpayers
- ▶ Propose changes to tax regulations
- ▶ Propose changes to the content of IRS rulings and instructions that may affect taxpayer rights
- ▶ Interpret IRS internal rules when required by the Treasury Ministry

General and Specific Anti-Avoidance Rules (GAAR and SAAR)

The bill would specifically list the SAAR to make them legally incompatible with the GAAR, so that when the IRS launches an audit under either the GAAR or SAAR, the IRS would be precluded from using the other rules.

The bill would modify the GAAR consultation procedure to allow taxpayers to request consultation on the SAAR as well. The bill also would reduce the time the IRS has to rule on the consultation.

Procedure and legal remedies

The bill would modify several procedures (e.g., business start-up, bylaws, liquidation) and require taxpayers to conduct those procedures online. The bill also would reduce the period for the IRS to rule on a RAV procedure from 90 to 60 days and establish an appeals process for RAV decisions.

Additionally, the bill would reduce the period for taxpayers to file a judicial tax claim from 90 to 60 days and establish rules that would allow the IRS and taxpayers to settle a claim during a court proceeding.

Transition measures and rules

The bill would establish rules for the transition from the attributed and semi-integrated tax regimes to the new fully integrated system. The bill also establishes rules for the transition from the current PYME regime to the new PYME regime.

In addition, the bill would establish a new “FUT” (undistributed taxable profits) substitution tax. Under the new provision, the bill would allow undistributed taxable profits accumulated until December 31, 2016, to be taxed at a special 30% tax rate, as a substitute for the IGC and WHT

rates. A corporate tax credit would apply to the substitute tax. After the substitute tax is paid, the bill would allow taxpayers to distribute profits to shareholders as nontaxable income up to the amount of profits that was subject to the substitute tax.

The bill would include a mechanism that would allow taxpayers to correct errors in the determination of tax equity in tax year 2019 or 2020.

Finally, the bill would establish an amnesty program under which taxpayers may voluntarily report undisclosed income and assets (located abroad) and be subject to a 10% “sole and substitute” tax on those undisclosed income and assets. The amnesty period would be available for 12 months after the bill is enacted. The amnesty program would apply to real estate (the 2014 amnesty did not include it).

Endnotes

1. In Chile, a shareholder also may be an employee. Wages, unlike dividends, are deductible and the deduction is currently capped.
2. IGC is the acronym of the income tax applicable to individuals.
3. That is, the IGC progressive rate is avoided.
4. Set forth in the 2014 tax reform.
5. CORFO is a government agency created to help bolster investment in Chile.
6. RAV stands for “administrative voluntary appeal,” and is an administrative legal recourse against a tax assessment.
7. Affirmative silence means that the applicant’s request is deemed granted if the legal term for an administrative decision lapses, and no resolution is given.
8. Discovery rules apply when the taxpayer refuses to provide specific information to the IRS, resulting in the taxpayer’s inability to produce that information as evidence during a judicial tax claim.

For additional information with respect to this Alert, please contact the following:

EY Consulting SpA (Chile), Santiago

- ▶ María Javiera Contreras maria.javiera.contreras@cl.ey.com
- ▶ Felipe Espina felipe.espina@cl.ey.com
- ▶ Alicia Domínguez alicia.dominguez@cl.ey.com
- ▶ Juan Antonio Rivera juan.antonio.rivera@cl.ey.com

Ernst & Young, LLP, Latin America Business Center, New York

- ▶ Ana Mingramm ana.mingramm@ey.com
- ▶ Enrique Perez Grovas enrique.perezgrovas@ey.com
- ▶ Pablo Wejcman pablo.wejcman@ey.com

Ernst & Young LLP (United Kingdom), Latin American Business Center, London

- ▶ Jose Padilla jpadilla@uk.ey.com

Ernst & Young Tax Co., Latin America Tax Desk, Japan & Asia Pacific

- ▶ Raul Moreno, *Tokyo* raul.moreno@jp.ey.com
- ▶ Luis Coronado, *Singapore* luis.coronado@sg.ey.com

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