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Chile's 2022 Tax Reform Proposals: A New Normal for Investors?

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INTRODUCTION: A SOCIAL AND POLITICAL EARTHQUAKE WITH AFTERSHOCKS

Chile is located within the "Pacific Ring of Fire," a long chain of volcanoes and active tectonic structures surrounding the Pacific Ocean. This makes Chile one of the most seismically active countries in the world.

Although earthquakes are unpredictable, based on the statistics of the last century, it is said that a significant earthquake should occur in Chile every decade or so. Considering that the last one occurred in 2010, we Chileans are expecting the next big event any day now.

In the last few years, Chile has experienced socio-political developments that have closely resembled earthquakes in terms of their sheer power, unexpectedness, and long-reaching repercussions. Among the aftershocks was a change in national government administration, significantly catalyzed by promises of substantial welfare programs and tax reform, including strong revenue-raising measures, to fund them.

This promised tax reform bill was presented to the Chilean Congress on July 1, 2022 (the Tax Reform Bill or "the Bill"). Its objective is to raise fiscal revenue progressively and to increase GDP by 4 points by 2026 via the introduction of new taxes, broader tax bases for existing taxes, and new measures against tax evasion and avoidance. In this article, we discuss the most significant pieces of the Tax Reform Bill that affect U.S. cross-border investors.

TAX REFORM PROPOSALS

1. From an Imputation System to a Classical System

Since 1984, Chile has had an imputation system in some form or another. As originally enacted, the imputation framework meant that, when Chilean companies distributed corporate earnings to their ultimate owners, the corporate income tax (CIT) paid by the distributing companies was fully credited against the owners' tax on their dividend income (i.e., the personal income tax (PIT) of individuals resident in Chile or the withholding tax (WHT) on non-resident shareholders).

The historical system remained unchanged in Chile for more than 30 years, until 2014. Pursuant to the 2014 reform, the full imputation system was replaced with the current, partial imputation regime, under which only 65% of the CIT is creditable against the tax of the owners. The full imputation regime did not disappear entirely, as it continues to apply to small companies with revenue under a specified statutory threshold. The full imputation system has also survived for non-resident owners that qualify for the benefits of an applicable tax treaty with Chile. Significantly, under a special temporary measure, owners

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resident in the United States and the United Arab Emirates are also eligible for full imputation until 2026, pending the applicable treaty's entry into force. The U.S. Senate Foreign Relations Committee greenlighted the U.S.-Chile Tax Treaty in March 2022. But timing on Senate approval is anyone's guess, especially in light of imminent mid-term elections.

The centerpiece of the Bill proposes to modify the general income tax regime, eliminating the partial imputation system and replacing it with a classical tax system. A dividend rate of 22% is proposed, against which the CIT will no longer be creditable.

Significantly, the Bill contemplates a special rule that maintains full imputation for shareholders residing in treaty jurisdictions. These investors will not see their tax situation affected in case the Bill becomes law (at least in this matter).

The Bill does not directly address the treatment of owners residing in countries with tax treaties signed but not yet in force (e.g., as the U.S. and the UAE). Without such a rule, those investors could lose the benefits of full imputation when the classical system goes into effect in 2025. U.S. investors will no doubt be hoping for a speedy conclusion to the U.S.-Chile Tax Treaty process, to take all doubts off the table.

2. Transition Tax on Retained Earnings

In light of the proposed conversion to a classical tax system, the Bill grants taxpayers a measure of transition relief with respect to earnings accrued before 2026. The transition rule would allow the payment of a substitute tax at a rate of 10% (in 2023 through 2025 for earnings accrued up until 2024) then 12% (in 2026 and 2027 for earnings accrued up until 2026). Compared to the ultimate 22% rate that would apply to distributions made after the end of the transition period, the substitute tax rates should provide an attractive incentive for taxpayers to purge retained earnings accounts. Note, the rules do not require taxpayers to distribute the earnings in order to access the substitute tax rates; those taxes apply automatically to earnings accrued in the specified periods. However, taxpayers that do not distribute these earnings might have a difficult time accessing them once the classical tax system takes full effect, as distributions are made from earnings on a ''last in, first out'' basis.

3. Non-Resident Quota Holders of Regulated Investment Funds

Quota holders of regulated investment funds would also be affected by the dis-integration of the tax system. The current 10% sole tax applicable to non-resident quota holders on profit distributions and capital gains on the sale of the quotas would be abolished and generally replaced with the 22% tax on profit distributions.

Non-resident quota holders who are resident in a country with a tax treaty in force with Chile would be allowed to access rate benefits from the current system, i.e., a 35% WHT and a deemed CIT credit of 27%. As a result, treaty-resident quota holders would be subject to overall taxation of 35% — compared to an overall taxation of 43% for non-resident quota holders who do not qualify for treaty protection.

4. ''Reduction'' of the CIT Rate

The Bill proposes a reduction of CIT, from 27% to 25%. This reduction, while voluntary, is not automatic. Effective as of 2025, a 2% ''Development Tax'' would replace 2% of CIT (and for all legal purposes would be considered CIT). Companies can either pay the 2% Development Tax in cash or engage in certain qualifying activities in Chile — investing in R&D, purchasing high-tech products and services, filing industrial property applications, and/or obtaining ISO certificates — for an equivalent amount. Either way, taxpayers would have a 27% economic burden. U.S. inbound investors might wonder whether the 2% Development Tax could be creditable in the United States. While there are good arguments for a favorable answer, it is a little too early to tell — particularly if the U.S. foreign tax credit rules continue to evolve. This would be yet another reason for U.S. investors to hope for a speedy conclusion to the U.S.-Chile Tax Treaty process.

5. 1.8% Anti-Deferral Tax on Retained Profits of Investment Companies

The Bill introduces a 1.8% tax on the retained profits of qualifying investment companies at least 50% of whose income is passive income (e.g., dividend, interest, rent, etc.). This new tax acts as an interest charge for the deferral of the shareholder-level taxes and would affect corporate structures including operating entities that are owned by a Chilean holding company. Notably, there is no flexibility for leasing companies or other ''active'' enterprises that earn one or more of the specified types of income, to avoid application of these rules. The new tax would be effective beginning in 2024, though the applicable rate during its first year would be 1%.

6. Restrictions on the Use of Loss Carryforwards

Tax losses will continue to be carried forward indefinitely. However, starting in 2024, taxpayers can

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only absorb loss carryforwards for up to 75% of taxable income; the limitation drops to 50% of taxable income starting in 2025.

7. New Foreign Tax Credit (FTC) Limitations

Several new limitations have been proposed on the use of FTCs by Chilean-resident companies. Currently, Chilean companies can credit foreign taxes paid by direct foreign subsidiaries as well as indirect foreign subsidiaries, so long as they maintain at least 10% equity ownership. Going forward, foreign taxes paid by indirect subsidiaries would no longer be creditable.

Additionally, FTCs would be eliminated with respect to Chilean WHT applied on income distributed abroad that is subsequently recognized by a Chilean entity (a round trip scenario).

Moreover, consistent with the conversion to a classical tax system, the maximum amount to be recognized as an FTC would be reduced from 35% to 27% (the CIT rate), and FTCs would no longer be usable against the relevant WHT or PIT of the shareholder (effective as of January 1, 2025).

8. Imposition of Capital Gains Tax for Listed Securities

Currently, capital gains from listed securities of companies listed in the Chilean stock market are exempt from tax. As of September 1, 2022, pursuant to legislation passed in February 2022, such recognized gains are subject to a sole 10% tax (subject to an exception for institutional investors). The Bill proposes to increase the sole tax rate to 22%.

9. Limitations on VAT Credit to Exporters

Reimbursement of VAT credit would be limited for exporters up to 19% (i.e., the current VAT rate) of the value of the exported items or services on the relevant month. There is currently no limit on the reimbursement amount, which is generally calculated based on the percentage of export sales (over total sales) of the taxpayer.

10. Amendments to the General Anti-Abuse Rule (GAAR)

Among several measures for diminishing tax avoidance, the most significant proposal would be amendment of the statutory GAAR. The Chilean IRS would be entitled to apply the GAAR without previous authorization from a Tax Court, as it occurs today. Administrative appeals against the qualification made by the tax authority will not be allowed; a challenge can only be resolved in court. In addition, the Bill would further facilitate application of the GAAR by repealing the ''specialty principle,'' which currently allows application of a special anti-avoidance rule to preclude application of the GAAR.

11. New Tax on Mining

Subject to pre-existing invariability of tax benefits pursuant to Law Decree N° 600, Law N° 20.026 and Law N° 20.469, the Bill proposes a new tax on mining royalties, effectively January 1, 2024.

Currently in Chile, mining income is subject to CIT and to a special tax on mining income. The Bill proposes modifications to the current rules, including a proposed ad-valorem component with respect to sales and another component with respect to mining income. The tax would therefore have two components.

The ad-valorem feature would apply to annual sales of copper; sellers would be subject to tax starting at 50K metric tons at a progressive effective rate of 1% to 4%.

The second feature would apply to adjusted taxable mining operational income at a 2% to 36% rate. Notably, the taxable base does not allow for any depreciation or amortization expense.

CONCLUSION

As we can see from the measures described above, the tax reform proposed is an ambitious one that implies the modification of Chile's traditional tax system and the creation of new taxes. Overall, the proposed reform presents the possibility of significant revenue increase and collection.

However, the Government does not have a decisive majority in the Chilean Congress, and the political forces in the Senate are balanced. In addition, in a referendum held on September 4, 2022, Chilean voters rejected the proposed adoption of a new Constitution, which had been officially promoted by the Government. This result was, to many, as unexpected as an earthquake, particularly given the astounding percentage of voters (nearly 62%) opposed to the change.

Thus, while not much is certain about the future of this Bill, the one thing taxpayers can count on is that quite a bit of political negotiation will be required to get this Bill over the finish line.

Stay tuned!

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