Protocol of Agreement

For a Tax Reform to a more inclusive Chile

Santiago, July 8th, 2014

The fiscal responsibility of financing permanent expenses with permanent income makes it imperative for the country to have a tax reform which will allow collecting 3% of GDP and improving income distribution through greater tax fairness, all in a context of proper incentives for saving and investing. To materialize such reform is a national mission, thus the need to build transversal agreements to give these changes which benefit the majority of our population sustainability in time.

With that end, the Chilean government represented by the Finance Minister, Mr. Alberto Arenas de Mesa, and the members of Senate's Finance Commission, led by its President, honorable Senator Ricardo Lagos Weber and Senators Juan Antonio Coloma Correa, José García Ruminot, Carlos Montes Cisternas, and Andrés Zaldívar Larraín, have reached the following agreement protocol, which represents the common will of perfecting the tax reform bill, in the matters herein indicated, so that said bill should be passed during the month of August of the present year.

These agreements will be materialized in amendments to the tax reform bill, which is currently in its second constitutional process in the Senate's Finance Commission. To that effect a technical work team will be formed, with representatives of all those who subscribe the present agreement.

1. Regarding incentives for saving and investing

a) Incentives for saving and investing for companies:

In addition to the integrated tax system with income attribution which the current bill contains, with a 25% corporate tax rate plus global complementary tax (rates ranging from 0% to 35%) and withholding tax (35% rate), a partially integrated tax system will be included – with its corresponding control rules destined to avoid possible tax avoidance – with a 27% corporate tax rate. Such system ends the current *fondo de utilidades tributables* (FUT) system, just as the current proposed income attribution system does, starting January 1, 2017 (tax year 2018). In this case dividends and profit distributions will be levied [in addition to the 27% corporate tax] with global complementary tax or withholding tax, with the same rates already described, with a credit of 65% of the corporate tax rate in force at the time of the dividend or profit distribution, thus ensuring the progressive nature of the tax system. The design of these systems should protect the regulations contained in double tax treaties signed by Chile. Taxpayers of Article 14 of the ITL[i] will have the possibility to choose any of the two described systems.

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[i] Chilean Income Tax Law.

An incentive to save will be included for companies which carry full accounting records and have annual sales up to UF 100,000[ii], by virtue of which they will be allowed to deduct from their corporate tax basis (as a tax expense) an amount equivalent to:

(i) 20% of the income which they reinvest, with a cap of UF 4,000[iii] a year, when they choose the attributed income regime.

(ii) 50% of the income which they reinvest, with a cap of UF 4,000[iv] a year, when they choose the partially integrated regime. In this case, dividend or profit distributions from the saved amount will not have a corporate tax credit (deductible from global complementary tax or withholding tax) in the corresponding proportion.

b) Incentives for saving and investing for individuals: mechanism of Article 54 bis of the reform bill will be strengthened

Such mechanism will be perfected, clarifying that the savings amount cap for the benefit is UTA 100[v] of annual flow.

Additionally, the reform bill will incorporate new providers and saving instruments which will be able to use the benefit and the mobility among them, matching it to the current treatment of *Ahorro Previsional Voluntario* (APV).

2. <u>Elimination of the 10% withholding</u>

3. <u>Smaller companies</u>

3.1 Presumed income

For taxpayers to access the presumed income regime, the maximum annual sales amount will change from UF 2,400[vi] which the current bill proposes to:

(i) UF 5,000[vii] in the case of transport,
(ii) UF 9,000[viii] in the case of agriculture, and
(iii) UF 17,000[ix] in the case of mining.

In addition, the new bill will establish the possibility for individual entrepreneurs and companies constituted only by individuals to subject themselves to this special tax regime.

Relation rules to stay in this regime will be modified, particularly regarding family relationships and those referred to investment in mutual funds and other tradable securities,

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[ii] Approximately US $5,000,000
[iii] Approximately US $200,000
[iv] Approximately US $200,000
[v] Approximately US $100,000
[vi] Approximately US $120,000
[vii] Approximately US $250,000
[viii] Approximately US $450,000
[ix] Approximately US $850,000

all within certain limits to be defined. Regardless of relationship, the criterion will refer to whether there is control or joint administration or not.

The initial capital amount for taxpayers joining the regime will be increased, from the proposed UF 3,000[x] to twice the annual sales limit, of the corresponding sector.

In order to facilitate the implementation of the proposed changes, this modification should enter into force starting commercial year 2016.

Lastly, there will be a reviewed valuation of lands for farmers who leave the regime. To that effect, Article 5 transitory of Law N°18.895 will be reinstated, adjusting the valuation rules and perfecting such article in order to avoid abuse, and such rule will be replicated for the change of agriculture taxpayers from the presumed income regime to the general regime.

3.2 Article 14 TER (PYME[xi])

Taxpayers subject to this regime who are partners of partnerships or companies by shares, both constituted only by individuals and individual entrepreneurs, from year 2017 onwards will have the option of being exempt of corporate tax.

The denomination of this Article will be modified, and will be named “Article 14 TER (PYME)”.

This simplified regime will be broadened, from companies with UF 25,000[xii] of annual sales to companies with an annual average of income derived from their business-line of up to UF 50,000[xiii].

The initial capital amount for taxpayers joining the 14 TER (PYME) regime will be increased to a maximum amount of UF 60,000[xiv].

The regulations which prohibit these enterprises from investing in mutual funds and other tradable securities will be modified, allowing these kinds of investments.

Additionally, the rules which lead to the exclusion of this regime will be modified, in order to avoid the situation in which small fluctuations in annual income (up to 20%) result in the end of the regime.

Received income and paid expenses will be considered for the determination of companies’ net taxable income, including the appropriate precautions to avoid abuse.

Consistently, for the calculation of monthly provisional payments (PPM), only companies’ received income will be considered.

For these companies, the date of payment of VAT will be increased for up to 2 months in relation to the current date.

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[x] Approximately US $150,000
[xi] Small and Medium Enterprises.
[xii] Approximately US $1,250,000
[xiii] Approximately US $2,500,000
[xiv] Approximately US $3,000,000.

We will allow those companies which, at the time of the law entering into effect, are subject to the regimes contained in Articles 14 bis and 14 quater, to continue in those regimes until December 31, 2016.

Finally, an exemption of withholding tax for advertisement and use and subscription of technological internet service platforms will be established for companies subject to Article 14 TER (PYME).

4. Cooperatives

We propose to legally define the concepts of the cooperative's operations with its cooperated and/or third parties, in order to provide certainty, avoiding future changes of interpretation of the IRS.

Cooperatives will be expressly incorporated into those entities offering instruments eligible for saving incentives for the people contemplated in the new Article 54 bis of the ITL.

5. Housing

The bill will clarify the maintenance of the special VAT credit for construction companies, through a general revision of the regulations in order to avoid any doubt regarding the transfer of respective discounts.

The UF 225[xv] cap for the special construction credit over each housing unit of up to UF 2,000[xvi] of construction value will be reinstated.

The bill will specify that land sales will continue to be exempt of VAT.

We intend to regulate the application of VAT for real estate projects which hold construction permits at the time of entering into force of the corresponding law, in order to facilitate the proper application of taxes.

We will make it clear that the sale of housing units which are financed, completely or partially, with housing subsidies delivered for the Vulnerable Segment, Emergent Segment and Middle Class (Supreme Decree N°49 and Supreme Decree N° 01 of the Housing and Urbanism Ministry) will not be subject to VAT.

The VAT law and its regulation will determine the parameters for the definition of habituality in real estate operations, limiting this burden to operations specific of the real estate business-line and avoiding that real estate liquidation, as a consequence of mortgage executions, is levied with VAT.

For individuals who are taxpayers of global complementary tax or labor tax, capital gains or profits obtained in the transfer of real estate will be a non-taxable income up to UF 8,000[xvii], regardless of the number of real estate properties that the taxpayer owns or transfers.

[xv] Approximately US $11,000
[xvi] Approximately US $100,000
[xvii] Approximately US $400,000

When capital gains taxes are proceeding for the transfer of real estate, in order to determine the acquisition value the taxpayer will have a choice between: i) the updated purchase value plus improvements which have increased its value, or ii) the official valuation at January 1, 2017 or iii) the real estate's fair market value, duly proved by the taxpayer at the time of publication of the law.

In any case, real estate of these taxpayers which were acquired at least 10 years before year 2014 will be subject to the regulations currently applicable according to the ITL.

Individuals will have a choice between paying the corresponding tax according to the rate calculated by the system contained in the tax reform bill, or a sole tax of 10%.

In the case of inherited real estate, the inheritance taxes will be a credit against the corresponding capital gains tax.

The abrogation of the real estate tax credit against the income tax of real estate investors will be gradual, with a 100% deductibility of the tax credit in tax year 2015, a 50% in tax year 2016, and the termination of the deduction in tax year 2017.

6. <u>IRS institutionalism and attributions</u>

The general anti-avoidance and anti-fraud rule (primacy of substance over form) will be specified, recognizing the good faith principle and the autonomy and freedom of contract of taxpayers, protecting the possibility to exercise option economy (the possibility to choose between legal, legitimate alternatives without being recharacterized, as long as the purpose of the taxpayer was not the avoidance of taxes, concept which will be legally defined) and adjusting its wording to that of our legal system.

The burden of proof will correspond, in a case of potential recharacterization, to the IRS and not to the taxpayer.

In order to apply the general anti-avoidance and anti-fraud rule, the competent tax and customs court will have to perform, through a procedure similar to that of complaint, the legal qualification of the potentially tax-avoiding or fraudulent act according to the requirement made to such court by the IRS director. Jointly with such qualification, the aforementioned court will rule regarding the corresponding penalties and will issue the corresponding orders to the tax administration.

The general anti-avoidance and anti-fraud rule will only apply to future acts, agreements, contracts and transactions, meaning those occurred after the entering into force of such rule.

One of the new subdirections of the IRS which will be created according to the reform bill will be destined to give the taxpayer the needed support, particularly regarding small enterprises in the area of tax assistance and education.

The IRS will create a public consultation space for questions regarding its rulings and other general instructions, through its institutional website.

The rule contained in the reform bill which allows for a renovation of the statute of limitations period in the case of investment justification will be eliminated.

The validity of IRS's e-mail notices and notifications to taxpayers will be limited only to those cases in which said taxpayers have specifically given their consent to be notified through e-mail.

The new bill will incorporate the possibility, for taxpayers subject to the Article 14 TER (PYME) regime, to have as penalty over their first violation of tax law the mandatory assistance to training courses.

During the second semester of the present year, a bill of law will be presented to Congress to propose the strengthening of tax and customs courts, dealing with the following aspects (among others): recognition of formation requirements for the access of tax and customs judges to the specialized courtrooms of the Courts of Appeals; regulation of the *imperium* of these jurisdictional organisms, and regulation of the conciliation process in the tax procedure.

The bill will contemplate the possibility to establish a previous consultation space for taxpayers to obtain from the IRS a timely, previous pronouncement regarding the tax effects of their possible transactions.

7. <u>Stamp tax</u>

In the case of DFL N°2 housing units which are currently subject to a 50% stamp tax reduction for their respective mortgage credits, such reduction will be increased to 75% in order to maintain the current stamp tax rate of 0.2% for operations related to these housing units.

8. <u>Foreign investment</u>

A bill of law will be presented to Congress which will propose a new institutionalism for foreign investment. Such bill of law should contain recommendations made by a transversal advice commission, headed by the Minister of Economy, Promotion and Tourism, who shall present its report in a 120-day period since the commission's formation. This new institutionalism will imply the abolition of the Decree Law N°600, currently in force.

9. <u>Green taxes</u>

We will clarify the application of the fixed-source emissions tax in order to incorporate those establishments which have an installed power equal to or larger than 50 MW.

Those sources which use biomass as fuel will be excluded from such tax.

We will narrow down the parameters to clearly determine the relevant parts of this tax in relation to local contamination. A regulation will determine only what might be subject to regulatory power.

Regarding the tax applicable to diesel lightweight vehicles, we will modify the procedure to exempt from taxes those taxpayers who acquire said vehicles for their businesses.

10. Capital gains for individuals (real estate, equity rights, shares)

Capital gains obtained by individuals who are not corporate taxpayers will be levied upon received income.

11. Corrective taxes

Regarding tobacco tax, the specific tax will be increased and the ad valorem tax will be decreased, thus increasing tax collection.

Non-alcoholic beverages will have a tax base of 10%; however, non-alcoholic beverages containing added sugar will be subject to a tax base of 18%.

Notwithstanding the foregoing, an experts commission coordinated by the Finance Ministry, aided by the Health Ministry will prepare a report which shall be presented to the Finance and Health commissions of Congress within a 60-day period, counting from the formation of such commission, with proposals to levy with taxes, in addition to those established for non-alcoholic sugary beverages, other high-sugar food items.

Regarding the specific alcoholic-beverage tax, a common tax rate of 22.5% will be established for wine and beer; regarding other alcoholic beverages, the system proposed in the current reform bill will be maintained.

12. Compensations

Given that one of the main objectives of the tax reform is to reach a larger tax collection of 3.0% of the PIB, the fiscal effect of some of the measurements previously described demand the compensation of the decreased collection which their incorporation will cause. Thus, the following measures should be incorporated:

Goodwill in excess of the FMV of assets will not be amortizable (currently it can be amortized over 10 years), but will be considered an intangible.

The recovering of withholding tax applicable to technical advice hired abroad as a provisional monthly payment (PPM) will be eliminated.

The transitory benefit of instant depreciation will be eliminated.

A fiscal traceability program destined to control the application of specific taxes will be incorporated.

A transitory regulation (of one year) will be introduced for the declaration of income or equity held abroad, under the strictest OECD standards regarding such matter.

13. Capital market and passive investments abroad

There will be adequations of rules regarding the capital market and passive investments abroad, in order to ensure their coherence and consistency with the alternative taxation

systems. In any case, regarding passive investments abroad only the concept of received or accrued of the foreign investment vehicle will be applied (CFC), reviewing its entering into force rule.

14. Chilean Fire and Rescue Service

The import of firetrucks and other specialized vehicles for the development of this institution's labor will be exempt of VAT and customs duties.

15. Others

The regime for the deduction of expenses incurred in supermarkets and similar establishments will be simplified, particularly regarding micro and small enterprises, raising the limit from UTM 1[xviii] to UTM 5[xix] for these kinds of expenses, and replacing the authorization request to the IRS for expenses larger than UTM 5, for the filing of an informative declaration.

The rules limiting and levying operations between family members will be modified.

The prohibition to deduct interest on loans used to finance corporate acquisitions will be eliminated, establishing a rule authorizing said deductions, with its corresponding control rules.

Article 41 H regarding excessive indebtedness will be reviewed, in order to ensure that it does not apply to debt acquired before the new rule's effectiveness.
The criterions used to define a country as a "Tax Haven" or a regime of low or null taxation of Article 41 F of the ITL will be reviewed.

The bail rule of tax obligations of controlling entities will be reviewed.

Article 21 of the ITL regarding rejected expenses will be reviewed, in order to adjust such rule to the incorporation of the new income tax regime.

Extreme and special geographical areas will maintain a differentiated tax regime, consistent with the new income tax regime.

Regarding information of bank accounts, we will send to Congress within one month the OECD Information Exchange Multilateral Agreement subscribed by Chile, for its processing.

We will increase for up to two months the period for VAT payment of companies with business-line sales of up to UF 100,000[xx].

[xviii] Approximately US $100
[xix] Approximately US $ 400
[xx] Approximately US $5,000,000

We will specify, among other attributions, the IRS's ability to challenge profit distribution agreements, making it a control rule under the general anti-avoidance and anti-fraud rule.

We will review the excessive-indebtedness rules (for example, eliminating the requirement of 50% of the net taxable income) and the CFC rule, for example regarding the precedency of credits for foreign taxes applied at different levels.