

LATAM Market Update

- **Chile: Tax reform—Preliminary agreement between Government and Opposition**
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CHILE: TAX REFORM—PRELIMINARY AGREEMENT BETWEEN GOVERNMENT AND OPPOSITION

The Government agreed on a “framework of understanding” with the opposition senators of the “Finance Commission” at the Upper House. The parties signed a draft agreement under which the Tax Modernization project presented by Sebastián Piñera on August 23, 2018, would have the votes for approval in the Senate.

This preliminary agreement mainly focuses on the achievement of the following objectives:

- Raise public funds, within a progressive tax framework, in order to finance the social agenda currently under discussion (approximately US\$1.2 billion);
- Support small and medium enterprises (SMEs), severely affected by the complex social scenario of recent weeks;
- Foster investment and economic growth (main pillar of the original tax reform);
- Alleviate the economic burden of the elderly (in parallel to the discussion on pension system reform).

In this regard, the framework of the preliminary agreement between the Ministry of Finance and the opposition implies a substantive modification of the original tax modernization project presented by the Government, giving way to a new set of measures that would shape a new tax system in Chile, such as:

1. **Reintegration of the tax system exclusively for SMEs:** The total reintegration of the corporate tax system—through which the shareholders can use as credit against their personal taxes, the entire First Category Tax paid by the company—has been considered as the core central of the original tax modernization project. However, the current agreement limits the application of the total integration system exclusively to SMEs whose sales do not exceed 100,000 UF (*Unidad de Fomento*: Inflation linked measure) (~US\$3.8 million). Consequently, the taxpayers currently subject to the partial integration system would remain in this regime if they had sales exceeding the 100,000 UF threshold.
2. **Wealth tax on high value real estate:** A new real estate tax on the residential properties whose fiscal valuation exceeds CLP 400 million (~US\$540,000). This tax would be implemented through an increasing and progressive rate.
3. **Gradual elimination of the Provisional Payment for Absorbed Profits (PPUA):** The agreement proposes the gradual elimination of the tax refunds that the holding companies receive today, whose losses have

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absorbed the profits received from their subsidiaries—which have previously been affected by First Category Tax—.

Along with the rejection of the total reintegration for large companies, the elimination of the PPUA constitutes one of the most relevant modifications in the tax regime, not only in relation to the bill originally presented by the Government, but also in relation to the current Chilean tax system in the last 35 years. The PPUA is considered as one of the main tax incentives for investment, so its elimination certainly represents a substantive modification to the legal framework and Chilean tax. However, the Government has not yet confirmed its acceptance of this point.

4. **Private Investment Funds (PIF) tax:** The agreement just signed incorporates a tax over capital gains and profits from PIFs, including minimum dividend allowances. Moreover, the opposition proposes to evaluate, in the medium term, taxes on other passive investment instruments.
5. **General Anti-Avoidance Standard:** Since its validity in 2015, the modification of this standard has been discussed. Even the Tax Modernization Project presented in 2018 included a new scope for this provision. However, the agreement just signed requires the preservation of the original anti-avoidance norm.
6. **Removal of a special regime for the repatriation of capital:** The possibility of opening a new special period within which to apply a reduced tax on capital (not previously declared) that are repatriated to Chile would be ruled out. This special regime was applied in 2015, with a rate of 8%, which let the Treasury of Chile raise an approximate amount of US\$ 1.5 billion.
7. **Removal of a new substitute regime for the Taxable Income Fund (FUT in *Spanish*):** As in the case of eventual repatriation of capital, the agreement would rule out the application of a new substitute tax for the FUT that remains still recorded in the accounting records of Chilean companies.
8. **Reintegration of the maximum marginal effective rate for the Complementary Global Tax of 40%:** As announced by the President of the Republic two weeks ago, the maximum marginal rate of 40% would be restored (eliminated by the 2014 tax reform).
9. **VAT tax credit for construction:** The current limit of 65% VAT tax credit for housing construction whose value does not exceed 2,000 UF (~ US\$75,000) will be maintained, discarding the modification made by the Chamber of Deputies in the discussion of the tax modernization project, which extended the value limit to 3,000 UF (~ US\$110,000).
10. **Broader depreciation regimes and sectoral/territorial benefits:** The details of this are not yet known, but it is stated as an incentive for the acquisition of capital goods and special regimes for investments made in certain regions of the country.
11. **Explicit obligation of investment companies with respect to commercial patent payment:** Divergences in administrative and judicial interpretations regarding the payment of commercial patents by investment companies would be terminated, establishing their obligation.
12. **Modification of the concept of “tax havens”:** The Tax Modernization Project incorporated more flexible criteria around the qualification of jurisdictions considered tax havens or low tax regimes. The preliminary agreement excludes the incorporation of this new standard in the bill currently under discussion.
13. **Elimination of DFL2 real estate tax benefits (residential estates with a surface of 140 sq. mt. or less):** Property owners who have reached the limit of two DFL2 units subject to tax benefits (in terms of Income Tax), will ordinarily pay taxes on all income from other DFL2 properties, eliminating all applicable tax benefits.
14. **Changes to the design of the Ombudsman's Office (DEDECON in Chile):** The agreement proposes improvement of the powers of this institution, particularly with regard to powers and conditions for the protection of SMEs.
15. **SME Regime:** Regarding the Income Tax, restrictive measures would be proposed so that high-income people or investment companies do not benefit from the tax regime for SMEs, applying the current regime (semi-integrated) on the profits obtained by companies or investment funds for their participation in SMEs, from dividends or capital gains.

The agreement also proposes that large companies will only be able to access the VAT tax credit (for sales or services provided by SMEs) if they pay their suppliers within 30 days. All in all, all of these measures are still under discussion. We consider that we can also have on the table the reduction in the Corporate Tax from 27% to 25% as an incentive for investment.

—Jorge Selaive, Carlos Muñoz & Waldo Riveras

MEXICO: INFLATION REMAINS WITHIN BANXICO'S TARGET IN OCTOBER

In October, headline inflation came in at 0.54% m/m, slightly above market consensus (+0.52%). This outcome was mainly driven by the seasonal increase in electricity tariffs, due to the roll back of summer subsidies in some cities, which was partially offset by a decline in some agricultural commodities and low octane gasoline. In its annual comparison, inflation increased from 3.00% to

3.02% between September and October (vs. 4.90% a year earlier), with its core component decelerating from 3.75% to 3.68% and non-core inflation increasing from 0.71% to 1.01%.

These prints reinforce our view that Banco de México will cut the overnight interest rate by 25 bps at its monetary policy meeting next week, given also the greater slack conditions in the economy—confirmed by last week's GDP preliminary estimate.

—Alejandro Stewens

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