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Tax treaty update: Discussion of provisions in United States-Chile income tax treaty

Representatives of the governments of the United States and Chile signed on February 4, 2010, an income tax treaty and protocol, which is the first income tax treaty between the two countries.

The United States-Chile income tax treaty must be approved by the U.S. Senate, and under the legislative process in Chile, before it will enter into force.

For an electronic version of the text of the treaty: **United States-Chile income tax treaty** [PDF 277 KB]

KPMG observation

The United States has only two income tax treaties in force with countries in Latin America: Mexico (1993) and Venezuela (1999). The United States-Chile income tax treaty clearly represents a new direction in U.S. tax treaty policy toward Latin America because of the numerous departures from the 2006 U.S. Model Income Tax Convention, especially with respect to taxation of income by the source state. The treaty with Chile is likely to pave the way for additional U.S. income tax treaties with countries in Latin America.

Some of the more noteworthy items included in the United-States-Chile income tax treaty (the "Treaty") are described below.

Permanent establishment (Article 5)

A building site or construction or installation project, or a drilling rig or ship used for the exploration of natural resource, creates a permanent establishment (PE) if the activity lasts for more than six months. The 2006 U.S. Model Convention specifies 12 months as the threshold.

The Treaty's expands the 2006 U.S. Model's definition of PE to include the performance of certain personal services in a state by an enterprise of the other state for an aggregate period of 183 days during any 12-month period. The provision is broader than the corresponding provision contained in either the 1980 United States-Canada income tax treaty or the commentary to the 2008 OECD Model Income Tax Convention.

For example, under the United States-Canada income tax treaty, the performance of services can create a PE for an enterprise only if either:

- An individual is present in the state to perform services for at least 183 days during any 12-month period and during that period, more than 50% of the gross active business revenues of the enterprise are derived from the performance of such services by that individual; or
- The services performed in the other state are provided for at least 183 days during any 12-month period, and they are performed with respect to the same or connected project for customers that are either resident in source country or contain a PE in the source country and such services are provided in respect of the PE.

The United States-Chile income tax treaty's services PE rule does not contain either of these limiting clauses. Thus, the Treaty will create a PE under a broader array of fact patterns (*e.g.*, when the services constitute a small percentage of an enterprise's business or when the services are provided for different projects or clients).

The Treaty includes a rule (not found in the 2006 U.S. Model) that makes an installation for the on-land exploration of natural resources (*e.g.,* a drilling rig) a PE if it continues for more than three months. This provision is apparently aimed at permitting Chile to tax companies that provide drilling services in Chile.

Business profits (Article 7)

The text of Article 7 of the Treaty itself generally follows the language in older versions of the OECD Model Convention on Income and Capital. However, the protocol to the Treaty adds a final sentence to paragraph 2:

> *Business profits to be attributed to the permanent establishment shall only include the profits derived from the* ***assets or activities*** *of the permanent establishment. [Emphasis added.]*

The 2006 U.S. Model includes a similar final sentence in paragraph 2:

> *For this purpose, the profits to be attributed to the permanent establishment shall include only the profits derived from the* ***assets used, risks assumed and activities performed*** *by the permanent establishment. [Emphasis added.]*

This language in the 2006 U.S. Model is intended to permit application of the "authorized OECD approach" (AOA) for attributing profits to a PE.* Observers believe the language in the protocol probably was intended to permit use of the AOA to determine the profits attributable to a PE under the Treaty.

*The OECD has proposed a revised version of Article 7 that would further describe the AOA and that would significantly change the language of paragraph 2.

Paragraph 8 of Article 7 provides that the United States may impose an excise tax on insurance premiums paid to foreign insurers and that Chile may impose an excise tax on insurance policies contracted with foreign insurers. The Treaty permits taxes in excess of the rates specified in IRC section 4371—2% in the case of reinsurance premiums and 5% in all other cases.

Dividends (Article 10)

The Treaty follows the 2006 U.S. Model with respect to the taxation of dividends. The source state generally may impose a 15% tax on dividends. This rate is reduced to 5% if the beneficial owner of the dividends directly owns at least 10% of the voting stock of the payor. Dividends paid to pension funds are tax-exempt. The Treaty, as amended by paragraph 14 of the protocol, follows the 2006 U.S. Model with respect to dividends paid to RICs and REITs.

Paragraph 7 of Article 10 permits the source state to impose a branch profits tax on a company resident in the other state at a 5% rate provided the company conducts business through a PE in the source state. [Chile does not have a branch profits provision.]

Paragraphs 12 and 13 of the protocol contain some limitations on the application of the Treaty's dividends article with respect to certain Chilean corporate taxes. With two exceptions, paragraph 12 provides that certain paragraphs of the Treaty's dividends articles—*e.g.*, reduced withholding tax rates and branch profits tax—do not apply to the second level of Chile's two-level income tax on business profits, when the first level is creditable against the second.

- The first exception provides that if Chile amends its two-level income tax so that there is no longer a credit mechanism, then the Treaty's dividends article will become fully applicable to the second level tax.
- The second exception provides that if Chile's second level tax rate exceeds 35%, then the dividends article will apply such that any income tax withholding does not exceed 15% of the gross amount of the dividends paid.

Paragraph 13 states that the Treaty's dividends article does not apply to dividends paid by an enterprise when the investment is subject to a foreign investment contract under Chile's Foreign Investment Statute (*DL 600*).

Interest (Article 11)

Unlike the 2006 U.S. Model, the Treaty permits the source state to tax interest. The Treaty permits a 4% withholding tax rate when the lender is a bank, an insurance company, an enterprise in the finance or lending business, an enterprise that sells machinery on credit when the interest is paid with respect to a sale of machinery on credit, and certain other debt-financed lenders. Chilean domestic law provides a similar 4% withholding rate for loans provided by foreign banks or foreign financial institutions.

In all other cases, during the first five years during which the Treaty is in force, the withholding tax rate is 15%; thereafter, this rate drops to 10%. Contingent interest is subject to a 15% withholding tax rate.

The interest article includes a unique anti-conduit provision. Under this provision, interest is subject to a 10% withholding tax if the interest is paid pursuant to a “back-to-back loan” or similar arrangement.

Royalties (Article 12)

The Treaty departs from the 2006 U.S. Model and permits a tax at source of 2% for royalties paid for the right to use industrial, commercial, or scientific equipment.

Royalties paid for the right to use other types of intellectual property (*e.g.,* copyrights, patents, trademarks and “other like intangible property”) are taxable at 10%.

Gain from the disposition of property giving rise to royalties is subject to tax at source at the rates described above, provided the gain is contingent on productivity, use or disposition of the property.

Of necessity, the Treaty provides a source rule for royalties that is similar to the rule contained in the 1989 United States-India income tax treaty. The rule departs from U.S. law and makes the residence of the payor—not the place of use of the intellectual property—the primary rule for determining the source of a royalty.

Capital gains (Article 13)

The 2006 U.S. Model exempts gains from tax at source, with the exception of gains from the disposition of real property interests (*i.e.,* it preserves the U.S. right to tax under section 897) and gain from the disposition of property attributable to a PE.

The Treaty permits the source state to tax gain from the disposition of shares, and “other rights” of a company resident in that state at a 16% rate, in certain cases (the “share gain tax”). The provision is applicable to gain on the disposition of shares of a Chilean company because the United States has no general tax on the sale of shares of U.S. companies.

Article 13 provides an exemption from this tax for:

- Pension funds
- Certain mutual funds and other “institutional investors” who sell shares on a recognized stock exchange in Chile

- Other investors in shares of a Chilean company that buy and sell the shares on a recognized stock exchange in Chile

These exceptions do not apply to a majority shareholder and certain major holders of other rights (*e.g.,* warrants).

Under U.S. sourcing rules, income from the sale of personal property is sourced to the residence of the seller. However, paragraph 5 of Article 23 (Relief from Double Taxation) of the Treaty provides that when an item of gross income is subject source state taxation, such item is sourced to that country. Therefore, U.S. persons subject to the Chilean share gain tax ought to receive a domestic foreign tax credit for any share gain tax paid.

Limitation on benefits (Article 24)

The Treaty's includes all of the various limitation on benefits (LOB) provisions found in the 2006 U.S. Model, with the following additions:

- Headquarters Companies—Paragraph 2(d) of the Article 24 provides the benefits of the Treaty to a "headquarters company." A nearly identical provision is included in the U.S. income tax treaty with the Netherlands.

- Triangular Provision—Paragraph 5 of the Article 24 addresses income derived through a PE located in a country other than the United States or Chile. Generally, if the combined rate of tax in the PE state and the residence state is less than 60% of the tax that would have been payable in the residence state if the income were earned in the residence state, then the source state may tax the income at a 15% rate in the case of interest dividends and royalties and under its domestic law with respect to other types of income. A similar provision is included in the U.S. income tax treaty with Switzerland.

Mutual agreement procedure (Article 26)

The Treaty follows the 2006 U.S. Model and does not contain an arbitration provision. In this respect, it is unlike many recent U.S. income tax treaties.

Limited most favored nation provision (Protocol)

Paragraph 22 of the protocol provides that if Chile concludes an income tax treaty that provides for a lower withholding tax rate for interest or royalties, or further limits the right of the source country to tax capital gains, the United States may initiate discussions to conclude a protocol that will provide such lower rates or limitations.

Ratification process

In the United States, ratification requires that a signed income tax treaty be forwarded to the U.S. Senate for advice and consent to ratification. The treaty is then referred to the

Senate Foreign Relations Committee for consideration. A public hearing for the treaty is typically held. The Senate Foreign Relations Committee must report the treaty out of the committee with a recommendation to the full Senate. Once the full Senate has approved the treaty, the tax treaty is referred to the U.S. State Department where the "Instrument of Ratification" is drafted and forwarded to the president for signature.

A provision in the Treaty provides that the United States and Chile will notify each other in writing, through diplomatic channels, when the ratification procedures are completed in each country. The Treaty will then enter into force on the date of the later of these notifications.

Effective dates

Once it enters into force, the Treaty's provisions will be effective:

- In respect of taxes withheld at source—for amounts paid or credited on or after the first day of the second month following the date on which the treaty enters into force

- In respect of other taxes—for tax periods beginning on or after January 1 of the calendar year immediately following the date on which the treaty enters into force

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