GMS Flash Alert

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United States - Analysis of U.S.-Chile Tax Treaty

On June 21, 2023, the U.S. Senate voted to approve the income tax treaty between the United States and Chile, clearing the way for its ratification.[1] This *GMS Flash Alert* focuses on the provisions of the treaty likely to be relevant to individual taxpayers on assignments between the two countries and their employers.

WHY THIS MATTERS

This new treaty is significant because it is one of only two U.S. treaties in force with a South American country (the other is with Venezuela) and is the first new treaty to be approved by the U.S. Senate in over a decade. The treaty will facilitate cross-border commerce and investments, including the movement of globally mobile employees between the United States and Chile, by reducing or eliminating double taxation on the same income.

Ratification of the treaty would be particularly significant for U.S. taxpayers seeking to claim foreign tax credits on their U.S. income tax returns for Chilean income tax. In the absence of an income tax treaty, tax professionals have been required to analyze Chilean income taxes to determine whether they are creditable for U.S. tax purposes or not. However, once the relief from double taxation article of the tax treaty becomes effective, Chilean income taxes that are treated as income taxes under the relief from double taxation article should be treated as creditable for U.S. tax purposes, provided they are paid by a citizen or resident of the United States that elects to use the benefits under the treaty. The timing of the entry into force and effective date of the treaty's provisions are discussed below.

Background and the Saving Clause

The treaty was signed on February 4, 2010.[2] A protocol and an exchange of notes to the treaty were signed on the same date. Certain important provisions, including the saving clause, are included in the protocol as opposed to the treaty itself. The saving clause reserves to each country the right to tax its residents and citizens as if the treaty had not come

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into effect, with certain exceptions. The saving clause is particularly significant for U.S. tax purposes because the United States taxes its citizens without regard to where they live and the saving clause is generally included in all income tax treaties to which the United States is a party. The effect of the saving clause on certain specific provisions of the treaty is discussed in more detail below.

Because the treaty was negotiated before the current U.S. Model Income Tax Treaty was issued in 2016, it is primarily based on the 2006 U.S. Model Income Tax Treaty ("2006 U.S. Model"). The following discussion of individual articles of the treaty highlights certain ways in which the treaty departs from the 2006 U.S. Model.

The Senate's approval of the treaty was subject to two reservations made necessary by changes to U.S. tax law that were enacted after the treaty was signed in 2010 and that relate to corporate taxation.[3]

Entry into Force

Chile originally completed its process of approval of the treaty in 2015, but without the reservations referred to above. As a result, Chile must now approve the reservations. The treaty will be ratified and enter into force once Chile completes that additional approval process and mutual notification of approvals by both countries is made by formal exchange of instruments of ratification.

To complete the process, these reservations must also be ratified by the Chilean Congress, following the established procedure outlined in the Political Constitution of Chile[4] and the Chilean Organic Law of Congress.[5]

Once these reservations are approved by the National Congress through the formal statutory procedures, the treaty will be considered validly concluded and incorporated into the Chilean national legal system. Subsequently, it should be ratified by the President of the Republic and published in the Official Gazette, in accordance with the provisions of the Vienna Convention on the Law of Treaties,[6] to which Chile is a state party.

However, the date on which the treaty enters into force is not necessarily the date on which each of its provisions takes effect. The provisions regarding withholding taxes will apply from the first day of the second month following its entry into force and all other provisions will apply beginning January 1 of the year following its entry into force. Thus, if the exchange of instruments of ratification is completed before the end of 2023, most provisions of the treaty would be effective commencing January 1, 2024. The provisions of Article 27, Exchange of Information, will go into effect from the date of entry into force.

Taxes Covered (Article 2)

The treaty applies to taxes on income and capital, including capital gains. imposed on behalf of either the United States or Chile, regardless of how the taxes are levied. With limited exceptions, state and local taxes and property taxes are not covered by the treaty. The existing taxes to which the treaty applies are the U.S. federal income tax imposed by the U.S. Internal Revenue Code (I.R.C.) and, in Chile, taxes imposed under the Income Tax Act (*Ley sobre Impuesto a la Renta*).

Social security and unemployment taxes are specifically excluded from coverage, even though they may be regarded as income taxes. U.S. and Chile social security taxes are dealt with in the bilateral Social Security Totalization Agreement of February 16, 2000, which entered into force on December 1, 2001.[7]

Residency (Article 4)

The new treaty provides residence determination rules for individuals and other categories of taxpayers, including tie-breaker rules used to determine a single country of residence when an individual is a tax resident under the domestic

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law of both the United States and Chile. Under this article, Chile will not treat a U.S. citizen or a green card holder as a resident of the United States unless that individual has a substantial presence, permanent home, or habitual abode in the United States and that individual must not be a resident of a third country.

Permanent Establishment (Article 5)

The purpose of the permanent establishment (PE) provision is to prevent double tax and to assign taxing rights to the treaty country with the most significant economic nexus (connection) to the business or investment activity. In general, the PE provision assigns taxing rights by providing that business profits of a resident of a treaty country may not be taxed by the other treaty country unless the treaty resident has a PE in the other treaty country. For example, the business profits of an enterprise resident in the United States are not subject to income tax in Chile unless the U.S. enterprise has a PE in Chile.

A PE includes a fixed place of business through which the business of an enterprise is wholly or partly carried on (e.g., a place of management, a branch, an office, a factory, etc.).

A PE can also be created by the activities of an agent of the enterprise within the other treaty country.

Under the new treaty, an enterprise is deemed to have a PE in the other treaty country if the enterprise performs services in that country for a period or periods exceeding, in the aggregate, 183 days in any twelve-month period. The services must be performed through one or more individuals who are present and performing the services in the other country. This particular provision, which can give rise to a "services PE", is not included in the 2006 U.S. Model.

For purposes of computing the 183-day time limit it is noted that:

- Non-working days such as weekends and holidays would not count toward the 183-day threshold as long as no services are actually being performed while the individual is in the other treaty country on those days.

- If an enterprise sends a number of individuals at the same time to the other treaty country to provide services, their collective presence during one calendar day will count for only one day of the enterprise's presence in the other country. For instance, if a U.S. enterprise sends 20 employees to Chile to perform services for a client in Chile for 10 days, the enterprise will be considered to have performed services in Chile for 10 days, not 200 days (20 employees x 10 days).

Customer support or other services provided by telephone or computer to customers located in the other country would not be covered by this provision because they are not performed by the enterprise within the other treaty country.

The provision applies only to the performance of services by an enterprise for third parties. Thus, the provision does not have the effect of deeming an enterprise to have a PE merely because services are provided to that enterprise.

If an enterprise is deemed to have provided services through a PE, the other treaty country may apply the Business Profits Article to tax the services on a net basis. Source-country tax would be limited to the profits attributable to the activities carried on in performing the relevant services.

Withholding at Source (Articles 10, 11, 12)

The treaty provides reduced withholding rates on income such as dividends, interest, royalties. In general, these categories of income are subject to full taxation in the country of residence of the payee but limited taxation in the source country. Dividends, interest, and royalties provisions are not excepted from the saving clause and the United States therefore reserves the right to tax U.S. citizens and residents on these categories of income, subject to the special foreign tax credit rules of Relief from Double Taxation Article, as if the treaty had not come into force.

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Dividends (Article 10)

Article 10 of the treaty generally follows the 2006 U.S. Model with respect to the taxation of dividends. The source country (i.e., the country of residence of the entity paying the dividend) generally may impose a 15-percent tax on dividends. This rate is reduced to 5 percent if the beneficial owner of the dividends directly owns at least 10 percent of the voting stock of the paying entity. Dividends paid to pension funds are tax-exempt from source country taxation.

The protocol includes some limitations on the application of the treaty's dividends article with respect to certain Chilean corporate taxes. Paragraph 12 of the protocol provides that the reduced withholding tax rates 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. To illustrate, Chile collects 35-percent tax on business profits imposed at two levels. The business profits of companies resident in Chile are subject to a 27-percent rate of tax (the "First Category Tax"). For nonresident shareholders, distributions are subject to a second-level tax (the "Additional Tax"), at a rate of 35 percent of the gross dividend distribution. Nonresident shareholders are allowed a credit for the 27-percent First Category Tax in computing their liability for the Additional Tax. Thus, the effective rate of Additional Tax after the credit is 8 percent.

There are two exceptions to this rule:

- 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 percent, then the Dividends Article will apply with the result that any income tax withholding does not exceed 15 percent of the gross amount of the dividends paid.

Interest (Article 11)

Interest income is also subject to full taxation in the country of residence of the payee and limited taxation in the source country. The rate of tax in the source country is limited to 10 percent, but this rule will be phased in. Thus, for the first five years from the date on which Article 11 takes effect, interest income is taxable at a rate not exceeding 15 percent in the source country and at a rate of 10 percent thereafter.

Banks, insurance companies, and certain other business entities are subject to 4-percent source-country taxation on interest income without a phase-in period.

This article of the treaty differs from the 2006 U.S. Model, which provides that interest income is generally exempt from source country taxation.

Royalties (Article 12)

Royalties are subject to full taxation in the country of residence of the payee and limited taxation in the source country. Royalties received as payments for the use of industrial, commercial, or scientific equipment are taxable at a rate not exceeding 2 percent of the gross amount payment and all other royalties (including payments for the use of copyrights, patents, trademarks, etc.) are taxable at a rate not exceeding 10 percent of the gross amount.

This article of the treaty differs from the 2006 U.S. Model, which provides that royalty income is generally exempt from source-country taxation, except in situations where the beneficial owner of the royalties carries on business in the source country through a PE and the right or property in respect of which the royalties are paid is effectively connected with the PE.

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Capital Gains (Article 13)

Gains derived from the sale of real property and from real property interests may be taxed in the country in which the real property is situated. Thus, for example, if a U.S. resident individual sells a house in Chile, both countries have the right to tax the gain, but the U.S. will be required to grant a foreign tax credit for Chilean tax paid on the gain, subject to the limitations of U.S. domestic law.

A special rule in Article 13 addresses gains from the sale of personal property that are attributable to a permanent establishment that an enterprise of one country has in the other country, or that are attributable to a fixed base available to a resident of one country in the other country for the purpose of performing independent personal services in that other country. This also includes gains from the sale of such a permanent establishment or of the fixed base itself. Such gains may be taxed in the country in which the permanent establishment or fixed base is located.

In connection with this rule governing gains from sales of personal property that are attributable to a permanent establishment, the Technical Explanation to the treaty states that a resident of Chile that is a partner in a partnership doing business in the United States generally will have a permanent establishment in the United States as a result of the activities of the partnership, assuming that the activities of the partnership rise to the level of a permanent establishment. The United States generally may tax a partner's distributive share of income realized by the partnership on the disposition of personal property forming part of the partnership's U.S. business property.

Gains realized by any taxpayer resident in one country from the sale of shares in a company that is a resident of the other country and whose shares are substantially and regularly traded on a recognized stock exchange located in that other country shall be taxable only in the seller's country of residence provided the shares are sold on such a recognized stock exchange or through a regulated public offering, and provided that the shares were previously acquired on such a recognized stock exchange, in a regulated public offering, through a placement or increase in share capital, or in exchange for convertible bonds.

In other situations, gains from the sale of shares in Chilean companies can be subject to Chilean tax of up to 16 percent, subject to conditions. In addition, gains from the sale of shares in company that is resident of one country and the seller is a resident of the other country who had an interest of 50 percent or more in the company during the 12-month period preceding the sale are subject to tax in the country where the company is resident. A similar rule applies to sales of other rights in the company, but with a 20-percent ownership threshold.

Under U.S. sourcing rules, income from the sale of personal property (which includes gain from the sale of shares) 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 to source-country taxation, the item is sourced to that country. Therefore, U.S. taxpayers subject to the Chilean share gain tax should receive a foreign tax credit on their U.S. tax return for any share-gain tax paid.

Article 13 also includes a rule providing relief from double tax for individuals subject to the U.S. expatriation tax under I.R.C. section 877A. This rule provides that where an individual who, upon ceasing to be a resident of the United States, is treated for purposes of U.S. tax has having sold property and is subject to U.S. tax on the deemed gain, the individual may elect to be treated for the purposes of Chilean tax as having sold and repurchased the property for its fair market value on the day before the individual's U.S. expatriation date. The effect of making the election is that only post-emigration gain will be subject to Chilean tax when there is an actual sale of the property while the individual is a resident of Chile. The election is subject to certain restrictions and limitations, including that it does not apply to property situated in Chile.

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Independent Personal Services (Article 14)

The independent Personal Services Article provides that the income from the performance of personal services in an independent capacity by a resident of the home country is taxable only in the home country unless the services are performed in the host country and the income is attributable to a fixed base regularly available to the individual in the host country for the purpose of performing the activities. Host-country taxation also applies if the individual of the home country is present in the host country for an aggregate period equal to or in excess of 183 days in a rolling 12-month period. Where the host country may tax independent personal services income, the host country may do so on a net basis, with all necessary expenses, including expenses not incurred in the host country, allowed as deductions.

This article applies to independent contractors and other professionals providing services in an independent capacity, but does not apply to company directors or artists and athletes.

The 2006 U.S. Model does not include an Independent Personal Services Article, but instead covers the income of self-employed individuals under the Business Profits Article, which generally subjects such individuals to host country tax if they have a permanent establishment in the host country to which their profits are attributable, and does not include a 183-day threshold.

Dependent Personal Services (Article 15)

The Dependent Personal Services Article follows the 2006 U.S. Model. It provides an exemption from host country tax for compensation earned by an individual resident in the home country and performing services in the host country provided (i) the individual is present in the host country for a period or periods not exceeding 183 days in any 12-month period that begins or ends in the tax year; (ii) the compensation is paid by or on behalf of an employer who is not a resident of the host country; and (iii) the remuneration is not borne by a permanent establishment that the employer has in the host country.

Directors' Fees (Article 16)

The Directors' Fees Article provides that a director's fee paid to a non-employee director who is a resident of one country in his capacity as a director of a company that is a resident of the other country may be taxed in the country where the payments arise. The fees are deemed to arise in the country in which the company is resident, except when they are paid in respect of attendance at meetings held in the other country.

Pensions (Article 18)

The pensions Article provides that income earned within a pension plan is not subject to taxation until actually distributed. Upon distribution from a pension plan established in one country to an individual resident in the other country, both countries have the right to tax the income, but the tax imposed by the source country cannot exceed 15 percent. This rule applies to both periodic distributions and lump-sum payments.

Article 18 includes an exception to country of residence's right to tax pension income whereby that country must exempt from tax any amount of such payment that would be exempt from tax in the country in which the pension plan is established if the recipient were a resident of that country. Thus, for example, a distribution from a U.S. Roth IRA to a resident of Chile would be exempt from tax in Chile to the same extent that the distribution would be exempt from U.S. tax if made to a U.S. resident.

Article 18 also includes a provision whereby an individual participating in a pension fund in his home country while performing services in the host country can deduct contributions to the home country plan for purposes of taxation in

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the host country. To claim this benefit, the individual must have been participating in the home country plan prior to commencing work in the host country, and the competent authority in the host country must determine that the pension fund generally corresponds to a host-country pension plan.

The Technical Explanation to the treaty includes a list of plans in each country that meet the latter requirement. Plans in the United States eligible for this benefit include qualified plans under I.R.C. section 401(a) (including I.R.C. section 401(k) arrangements), individual retirement plans (including individual retirement plans that are part of a simplified employee pension plan that satisfies section 408(k), individual retirement accounts, and IRC section 408(p) simple retirement accounts), I.R.C. section 403(a) qualified annuity plans, I.R.C. section 403(b) plans, I.R.C. section 457(g) trusts providing benefits under I.R.C. section 457(b) plans, and the Thrift Savings Fund (I.R.C. section 7701(j)). Plans in Chile qualifying for this benefit include any pension fund administered by the *Instituto de Prevision Social* (formerly *Instituto de Normalización Previsional*) and the social security system created by Decree Law 3500 (DL 3500).

This benefit is also subject to a time limit of 60 months, and is not available to any U.S. citizen or green card holder. The 2006 U.S. Model includes a similar provision, but without the 60-month time limit.

Students and Trainees (Article 20)

Under the Students and Trainees Article, payments received by a student, apprentice, or business trainee will be exempt from host-country taxation provided the payments arise from, or are remitted from, sources outside the host country. To claim the exemption benefit, the individual must have been a resident of the other treaty country either at the time of arrival in the host country or immediately before, and the purpose of the visit must be full-time education at a recognized educational institution, or full-time training.

For an apprentice or business trainee, the treaty exemption from host country tax applies for a period of no more than two years starting from the date the individual first arrives in the host country for training. Under U.S. domestic law, compensation paid by a non-U.S. employer to a nonresident individual present in the United States on an F, J, or Q visa is excluded from the exchange visitor's gross income. Thus, amounts received by a business trainee will be exempt for a tax year when the non-U.S. employer, residency, and visa status requirements are satisfied and without regard to the two-year limitation provided in the treaty.

Relief from Double Taxation (Article 23)

The Relief from Double Taxation Article is similar to the 2006 U.S. Model provision. It provides that the United States will use the foreign tax credit method to relieve double taxation. A special credit and resourcing rules are provided to mitigate double taxation against U.S. citizens residing in Chile who are taxed solely by reason of their U.S. citizenship under the saving clause. The United States agrees that Chile, in imposing its tax based on residence, is required to credit only the U.S. tax that would have applied to the U.S.-source income of a resident of Chile who is not a U.S. citizen. Thus, the United States will permit a U.S. citizen residing in Chile to resource enough U.S.-source income as foreign source to prevent double taxation of the same income.

The Chilean taxes eligible for credit for U.S. income tax purposes are all taxes imposed under the Chilean Income Tax Act (*Ley sobre Impuesto a la Renta)* other than taxes on capital, and any identical or substantially similar taxes imposed by Chile after the date of signature of the treaty in addition to, or in place of, the existing taxes.

FOOTNOTES:

1 For prior coverage, see *GMS Flash Alert* 2023-114, 22 June 2023.

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2 Read text of the United States-Chile income tax treaty as signed on February 4, 2010; Read the U.S. Treasury Department's technical explanation of the treaty with Chile.

3 The first reservation clarifies that the treaty shall not prevent the imposition of the base erosion and anti-abuse tax (BEAT) under U.S. Internal Revenue Code (IRC) section 59A, and the second modifies Article 23 (Relief from Double Taxation) of the treaty to account for the repeal of the indirect foreign tax credit under former IRC section 902 and its replacement with the dividends received deduction under IRC section 245A.

FOOTNOTES (cont'd):

4 Biblioteca del Congreso Nacional (BCN). *Constitución Política de Chile*: https://www.bcn.cl/leychile/navegar?idNorma=242302 .

5 Biblioteca del Congreso Nacional (BCN). *Ley Orgánica del Congreso*: https://www.bcn.cl/leychile/navegar?idNorma=242302&idParte= .

6 United Nations. Vienna Convention on the Law of Treaties (1969). https://legal.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf .

7 See U.S.-Chilean Social Security Agreement, as signed on February 16, 2000.

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