US Tax Treaty Newsalert

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Chilean Treaty sent to US Senate for ratification

On May 17, 2012, President Obama transmitted to the US Senate for ratification the new income tax treaty, protocol and exchange of notes signed by the governments of Chile and the United States on February 4, 2010, which have been corrected by subsequent exchanges of notes signed on February 25, 2011, and more recently, on February 10 and 21, 2012 (the Proposed Treaty).

The Proposed Treaty is a significant development in US tax treaty negotiations in that it is only the second US tax treaty signed with a South American country (the first was signed with Venezuela in 1999) and is the first bilateral income tax treaty between the United States and Chile.

The president must obtain the advice and consent of the US Senate before the Proposed Treaty can be ratified. Two-thirds of the Senate is required to approve the resolution of ratification of a treaty. Following this approval, Chile and the United States must exchange the ratification instruments for the Proposed Treaty to enter into force.

> ***Observation*:** The US Senate Foreign Relations Committee has not yet scheduled a hearing date to consider the Proposed Treaty. Typically, the Committee holds one hearing per year on tax treaties and trade agreements and does not schedule hearings until there is a critical mass (unquantified) of pending tax and trade agreements.

> At a recent ABA Tax Section meeting, Michael Caballero, the Treasury International Tax Counsel, identified two pending agreements -- with Norway and Poland -- as in the final stages of signature, the last step before a tax agreement is sent to the Senate. Last year, three agreements (a new income tax treaty with Hungary and protocols to the income tax treaties with Switzerland and Luxembourg) were reported out by the Committee to the full Senate with the recommendation they be approved. Ordinarily, the full Senate follows the recommendations of the Committee, and generally will approve the proposed agreements by unanimous consent. However, these three agreements have not been approved by the full Senate because Senator Rand Paul (R-KY) has placed a hold on the Senate's approval of these agreements. Senator Paul's action leaves the tax treaty ratification process in a state of flux.

It should be noted that the Proposed Treaty, which was the result of several years of negotiation between the United States and Chile, may be subjected to greater scrutiny during the ratification process due, in part, to its unique nature. Specifically, the Proposed Treaty incorporates principles that are unique to tax agreements with developing countries. For example, the Proposed Treaty cedes significant source State taxation to Chile in the case of parent-subsidiary dividends, interest and royalties. In this regard, the Proposed Treaty does not provide US multinational corporations directly investing in Chile access to certain benefits that are incorporated into most other US bilateral income tax treaties.

> ***Observation:*** Hopefully ratification of the Proposed Treaty will open the door to more US tax treaties with Latin American nations. US corporations with investments in Latin America may not welcome some of the Proposed Treaty's standards, particularly the unilateral reduction in the taxation of dividends and a rather expansive definition of permanent establishment. However, based on recent public comments by a US Treasury Department representative, it is unlikely that the Proposed Treaty will form the framework for the negotiation of additional bilateral income tax treaties between the United States and other Latin American countries, such as Brazil or Argentina.

Below is a brief summary of the Proposed Treaty's most noteworthy aspects. For complete coverage on the provisions of the Proposed Treaty, please refer to PwC's US Tax Treaty Newsalerts issued on February 8, 2010 and February 24, 2010.

Selected provisions of the Proposed Treaty

Expansive definition of Permanent Establishment

The Proposed Treaty provides special definitions for certain natural resource-related activities. In particular, it provides that a permanent establishment includes:

- an installation used for on-land exploration of natural resources if it lasts or the activity continues for more than three months; and
- a building site or construction or installation project and the supervisory activities in connection with on-land exploration, or a drilling rig or ship

used for the exploration of natural resources if it lasts or the activity continues for more than six months.

In addition, the Proposed Treaty provides that a permanent establishment includes an enterprise of one country that performs services in the other country for a period or periods exceeding in the aggregate 183 days in any twelve month period, and these services are performed through one or more individuals who are present and performing such services in that other country.

One-sided reduction in dividend taxation

Article 10 of the Proposed Treaty provides that dividends may be taxed by the Contracting State in which the payor is resident (the source State). Source State taxation is limited to 5 percent in cases where the beneficial owner of the dividends is a company that directly owns at least 10 percent of the voting stock of the payor. In all other cases, source State taxation is limited to 15 percent. The Protocol, however, essentially renders inapplicable the provisions of Article 10 with respect to dividends paid by companies resident in Chile. The Chilean rate of tax that applies with respect to dividends paid by Chilean resident companies depends on whether the dividend is attributable to profits subject to Chile's First Category Tax or Additional Tax. See the linked February 24, 2010 Newsalert for further details.

Taxation of interest

The Proposed Treaty generally permits taxation of interest at a rate of 10 percent (15 percent for the first five years after the interest provisions enter into force) except that a 4 percent rate will apply for interest paid to the following:

- a bank;
- an insurance company;
- an enterprise that derives a substantial portion of its gross income from the active and regular conduct of a lending or finance business involving transactions with unrelated parties, where the enterprise is unrelated to the payer of the interest;
- an enterprise that sold machinery or equipment, where the interest is paid in connection with the sale on credit of such machinery or equipment; or
- certain other enterprises substantially engaged in public financial markets or deposit-taking activities with unrelated persons.

In the case of back-to-back loans that would otherwise qualify for the 4 percent rate, the rate is 10 percent. In addition, contingent interest is subject to a maximum rate of 15 percent.

Taxation of royalties

Royalties may be taxed pursuant to the Proposed Treaty at the rate of 2 percent on payments made as consideration for the use of, or the right to use, industrial, commercial or scientific equipment. The rate is 10 percent for payments made as consideration for the use of, or the right to use, any copyright of literary, artistic,

scientific or other work (including computer software, cinematographic films, audio or video tapes or disks, and other means of image or sound reproduction), any patent, trademark, design or model, plan, secret formula or process, or other like intangible property, or for information concerning industrial, commercial, or scientific experience. In addition, the Proposed Treaty contains a special sourcing rule which generally provides that royalties are deemed to arise in the country of the payor unless the royalties are borne by a permanent establishment, in which case they are sourced to the location of the permanent establishment. In order to determine whether payments made for computer software should be classified as royalty payments, the treaty will follow definitions provided under the Commentary to Article 12 of the OECD Model Tax Convention on Income and on Capital of 2008.

Limitation on Benefits (LOB) article

The Proposed Treaty contains a modern LOB article that is consistent with other recent treaties. It is worth noting that for purposes of the test applicable to publicly traded companies, the Proposed Treaty requires that a company also satisfy the requirements of a substantial presence test based either on where the company's shares are traded or where the company is principally managed.

The Proposed Treaty also contains a so-called triangular branch rule that will affect the rate of tax applicable to income attributable to branches of companies. This will apply where the branch is located in a third country and the combined taxation of the income by the treaty country and the country in which the branch is located is less than 60 percent of what the applicable home office country tax rate would have been had the income been fully taxable by the home office country. Dividends, interest, and royalties earned by those branches from sources in the other treaty country will generally be subject to a 15 percent tax rate. Exceptions will be provided in the following circumstances:

- with respect to royalty income where the underlying intangible was developed by the third-country branch; and
- where the third-country branch is engaged in the active conduct of a trade or business *other than* making or holding investments for the company's own account. (This rule will not apply to registered securities dealers or banks.)

Effective dates

The Proposed Treaty generally will enter into force on January 1 of the year following the exchange of instruments of ratification. For taxes withheld at source, the Proposed Treaty will be effective for amounts paid on or after the first day of the second month following the exchange of instruments of ratification.

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