EXPLANATION OF PROPOSED INCOME TAX TREATY BETWEEN THE UNITED STATES AND CHILE

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

On February 26, 2014

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed income tax treaty between the United States and Chile (the "proposed treaty"). The proposed treaty was signed on February 4, 2010, and is accompanied by a protocol (the "proposed protocol") and by official understandings implemented by exchanges of diplomatic notes carried out on that same day, on February 25, 2011, and on February 10 and 21, 2012 (the "2010 diplomatic notes," the "2011 diplomatic notes," and the "2012 diplomatic notes"). The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed treaty for February 26, 2014.[2]

Part I of the pamphlet provides a summary of the proposed treaty. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III provides a brief overview of Chile's tax laws. Part IV provides a discussion of investment and trade flows between the United States and Chile. Part V explains, in order, each article of the proposed treaty, including related provisions of the proposed protocol and the diplomatic notes, followed by those proposed protocol paragraphs not directly related to an article of the proposed treaty. Part VI describes issues that members of the Committee on Foreign Relations may wish to consider in its deliberations over the proposed treaty.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Chile* (JCX-10-14), February 24, 2014. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at http://www.jct.gov.

[2] For a copy of the proposed treaty, see Senate Treaty Doc. 112-8.

I. SUMMARY

The principal purposes of the proposed treaty are to reduce or eliminate double taxation of income earned by residents of each country from sources within the other country, and to prevent avoidance or evasion of the taxes of the two countries. The proposed treaty also is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

For example, the proposed treaty includes provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article 7). Similarly, the proposed treaty includes certain exemptions under which residents of one country performing personal services in the other country will not be required to pay tax in the other country unless their contact with the other country exceeds specified minimums (Articles 14 and 15).

The proposed treaty provides that dividends, interest, royalties, and certain gains derived by a resident of one country from sources within the other country generally may be taxed by both countries (Articles 10, 11, 12, and 13). The proposed treaty, however, provides limits on the rates of tax that the source country may impose on a resident of the other country on dividends, interest, and royalties.

In situations in which the country of source retains the right under the proposed treaty to tax income derived by residents of the other country, the proposed treaty generally provides for relief from the potential double taxation through the allowance by the country of residence of a tax credit for certain foreign taxes paid to the other country (Article 23).

The proposed protocol includes (in paragraph 4) the standard U.S. treaty provision, referred to as the saving clause, under which each country retains the right to tax its residents and citizens as if the treaty had not come into effect. The proposed protocol also includes (in paragraph 2) the standard provision that the treaty may not be applied to deny any taxpayer any benefits to which the taxpayer would be entitled under the domestic law of a country or under any other agreement between the two countries.

The proposed treaty (Article 20) generally provides that students and business trainees visiting the other treaty country are exempt from host country taxation on certain types of payments received.

The proposed treaty provides authority for the two countries to resolve disputes (Article 26) and exchange information (Article 27) to carry out the provisions of the proposed treaty.

The proposed treaty includes an article (Article 22) generally providing exclusive residence country taxation of capital. Neither the United States nor Chile impose taxes on capital that would be covered by this article.

The proposed treaty also includes (in Article 24) a detailed limitation-on-benefits provision that reflects the anti-treaty-shopping provisions included in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model treaty") and more recent U.S. income tax treaties. The rules are intended to prevent the inappropriate use of the treaty by third-country residents.

The provisions of the proposed treaty will have effect generally for taxable periods beginning on or after January 1 of the calendar year immediately following the date on which the proposed treaty enters into force. With respect to withholding taxes (on, for example, dividends, interest or royalties), the proposed treaty has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force.

The rules of the proposed treaty generally are similar to rules of recent U.S. income tax treaties, the U.S Model treaty,[3] and the 2010 Model Convention on Income and on Capital of the Organisation for Economic Cooperation and Development (the "OECD Model treaty"). The proposed treaty does, though, include certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed treaty in Part V of this pamphlet.

[3] For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules

The United States taxes its citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all of their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected through withholding. Certain payments of U.S.-source income paid to foreign financial institutions and other foreign entities also are subject to withholding tax at a rate of 30 percent unless the foreign financial institution or foreign entity is compliant with specific reporting requirements.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Notwithstanding this general rule that dividends and interest are sourced based upon the residence of the taxpayer making such a payment, special rules may apply in limited circumstances to treat as foreign source certain amounts paid by a U.S. resident taxpayer and treat as U.S. source certain amounts paid by a foreign resident taxpayer.[4] Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to credits for foreign taxes imposed on foreign oil and gas extraction income and foreign oil related income.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

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[4] For tax years beginning before January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. Although this provision generally was repealed for tax years beginning after December 31, 2010, other rules still apply to treat certain payments of interest by a foreign bank branch or foreign thrift branch of a domestic corporation or partnership as foreign source. Similarly, several rules apply to treat as U.S. source certain payments made by a foreign resident. For example, certain interest paid by a foreign corporation that is engaged in a U.S. trade or business at any time during its taxable year or has income deemed effectively connected with a U.S. trade or business during such year is treated as U.S. source.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is foreseeably relevant to carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that, notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service ("IRS") and the treaty partner's tax authorities also can request specific tax information from a treaty partner. These requests can include information to be used in criminal investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain "anti-treaty shopping" provisions designed to limit treaty benefits to bona fide residents of the two countries.

III. OVERVIEW OF TAXATION IN CHILE[5]

A. National Income Taxes

<u>Overview</u>

The Republic of Chile is a unitary republic[6] divided into fifteen regions, which are subdivided into provinces and municipalities. Chile imposes an income tax on individual and corporate net incomes at the national level, while business activities are also subject to business license fees levied at the municipal level. Residents are subject to tax on their worldwide income, while nonresidents are subject to the tax on their Chilean-source income. Foreign tax credits are generally available to individual and corporate residents. The definition of income subject to tax is expansive and includes capital gains.

Income sources are divided into four principal categories of taxation: (a) business income tax ('*impuesto de primera categoria*'), the First Category Tax, which is levied on business income under applicable corporate income tax regulations; (b) employment income tax ('*impuesto de segunda categoria*'), the Second Category Tax, levied on employment income; (c) individual income tax ('*impuesto global complementario*'), the Complementary Tax, levied on an individual's total net taxable income subject to credits given for any business and/or employment income tax the individual has already paid; and, (d) non-resident income tax ('*impuesto adicional*'), the Additional Tax, levied on Chilean source income derived by non-residents.

<u>Individuals</u>

Chilean residents are subject to tax on their worldwide income. A resident, for tax purposes, is an individual who was present in Chile for a period greater than six months in a given calendar year, or in any given two calendar years. Joint returns are not permitted; each taxpayer must file a return. The husband reports any income derived from marital property on his return.

The Chilean income tax system generally provides for inflation adjustments and measures taxable income based on monthly and annual tax units. Marginal tax rates are applied based on these tax units. Chile applies a progressive rate system with current rates ranging from

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[5] The information in this section relates to foreign law and is based on the Joint Committee staff's review of publicly available secondary sources, including in large part Banco Central de Chile, Economic Statistics, available at http://www.bcentral.cl/eng/economic-statistics/series-indicators/index.htm (largely in Spanish), IBFD Latin American Tax Surveys, Chile, available at http://checkpoint riag.com, Business Operations in Chile, Tax Management Portfolio No. 997-1st, available at http://taxandaccounting.bna.com/btac/, and Deloitte LLP International Tax and Business Guide: Chile, available at http://www.deloitte.com. The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made.

[6] A unitary republic form of government is one in which the central government is the primary source of power and administrative divisions exercise only powers delegated by the central government. See http://en.wikipedia.org/wiki/Unitary_republic.

zero percent to 40 percent; the 40 percent marginal rate applies to any income above 150 annual tax units (approximately $135,146).[7] Income up to 13.5 annual tax units (approximately $12,163) is exempt from tax.

Investment income is generally subject to tax. While dividend income is taxable, a credit system attempts to offset the double taxation at both the corporate and shareholder levels. Specifically, individual shareholders must gross up their dividend income to include the corporate tax paid and apply the individual tax rate on the grossed up amount. However, a credit is then available to offset the business income tax paid on the underlying dividend against the individual tax due. Capital gains are generally subject to business income tax and individual or non-resident income tax. However, individuals may claim a credit for paid business income tax. Certain capital gains are exempt or subject to preferential rates. Capital gains realized on the sale of shares which an individual has owned for over a year are subject to a flat 20 percent business income tax and not subject to a further individual income tax if the said individual does not habitually buy or sell shares and the transaction is not carried out among shareholders that own 10 percent or more of the shares of the underlying company or among a shareholder and a related entity. Capital gains realized on the disposition of real property is exempt from tax if the property is not part of the assets of a taxpayer subject to business income tax and such taxpayer has held the property for more than one year and does not habitually buy and sell properties. Resident individuals may credit 15 percent of the year's registered net investments (*i.e.*, investments less withdrawals) with financial institutions and defer payment of income tax on those investments until withdrawal. If a person has net investments for four consecutive years, subsequent annual withdrawals, up to a 10 annual tax unit limit, are not subject to tax. Withdrawals exceeding 10 annual tax units are subject to tax at a 15 percent rate.

Individual taxpayers also benefit from certain exemptions and allowances. Income from "movable capital" (interest income), and capital gains derived from the sale of stock in joint-stock companies are exempt provided they each do not exceed 20 monthly tax units. Individuals earning professional income may deduct necessary expenses from their gross income. However, losses incurred by individuals may not generally be set off, except where individuals are also subject to business income tax. In that case, losses may be carried forward indefinitely. Individuals may also offset certain investment income and capital gains against capital losses, but such losses may not be carried forward. Residential mortgage expenses can also be deducted. Resident individuals are eligible for a credit for education expenses for children (up to 25 years old), subject to certain limitations.

Corporations

Chilean resident corporations are subject to business income tax[8] on their worldwide income. Residence is determined by place of incorporation. The business income tax rate is 20

[7] For February 2014, the Annual Tax Unit was CLP 494,172 or $900.97, based on the January 30, 2014 exchange rate between the Chilean Peso and the United States Dollar, http://www.exchange-rates.org/converter/CLP/USD/494172/Y.

[8] Note that business income tax is also referred to as the First Category Tax ('*impuesto de primera categoria*').

percent. Any person undertaking any business activity is generally subject to business income tax, whether incorporated or not. Inter-company dividends from resident corporations are exempt. Flow-through entities generally do not exist for Chilean tax purposes. Beyond business income tax, corporations are subject to a business license tax calculated based on an entity's capital and payable to municipalities. Business license taxes generally vary between 0.25 percent and 0.50 percent of an entity's capital; they may not be less than one tax unit but may not exceed 8,000 tax units.

As stated, the Chilean tax system provides adjustments for inflation. Income subject to business income tax consists of gross income less necessary expenses to produce that income. Deductible expenses include intellectual property expenses. However, deductions for foreign royalty expenses paid to a related party are capped at four percent of the Chilean entity's annual income. In addition, various tax credits are given, including research and development and employment credits. Tangible capital assets must be capitalized and are subject to deductions for depreciation. After deducting necessary expenses, gross income is subject to the following inflation adjustments: (a) shareholders' equity at the beginning of the taxable year regarding increases in capital during the taxable year; (b) taxpayer's liabilities; (c) dividends or profits received from legal entities incorporated in Chile; (d) reductions in shareholder equity at the beginning of the taxable year; and, (e) changes in the taxpayer's assets.

Income arising from capital gains is generally considered ordinary income and subject to business income tax. However, capital gains realized on the disposition of certain shares and real property are either exempt or benefit from reduced rates. Capital gains arising from the sale of shares acquired before 1984 are exempt. Capital gains arising from the sale of shares acquired after 1984 are subject to a flat 20 percent business tax and are not subject to further individual income taxes if the selling shareholder owned the shares for at least one year, does not habitually buy or sell shares and the transaction is not carried out among shareholders that own 10 percent or more of the shares of the underlying company or among a shareholder and a related entity. Moreover, capital gains arising from the sale of real property are exempt if the seller owned the property for more than one year, does not habitually buy and sell real property and the property is not sold among shareholders owning 10 percent or more of the shares of a company or among a shareholder and a related entity.

In addition, in computing capital gains realized on certain properties, taxpayers may adjust their basis amounts for inflation. The adjusted amount is not subject to tax. Specifically, a basis adjustment is available for shares in a joint stock corporation held for over a year, bonds and debentures transferred to the issuing corporation and intellectual property, provided the seller is the inventor or author of the sold property. Under tax incentives to encourage capital investment, capital gains arising from a publicly listed resident company are exempt if the shares are "sold on the stock exchange through a contribution of securities to a mutual investment fund." Additionally, certain capital gains arising from the disposition of resident corporate bonds are subject to tax preferences.

Chile has adopted a business platform regime aiming to attract foreign investors to set up a holding company structure in Chile used to invest in third countries. A platform company must be incorporated in Chile as an open or closed joint-stock company and may invest abroad and in public Chilean companies. An entity that satisfies 'platform company' requirements is deemed a nonresident and therefore not subject to Chilean tax on its foreign source income. Dividends received by platform company nonresident shareholders relating to income generated from foreign sources is exempt from Chilean tax. Similarly, capital gains realized on the sale of platform company shares relating to "increases in nonresident affiliates" of the platform company are exempt. While Chilean residents may invest in platform companies, they will be subject to tax on any related income.

Taxpayers may offset business income with losses incurred, which may be carried forward indefinitely. Note that there are no specific restrictions on the use of capital losses. However, Chile does not allow for the filing of consolidated returns; therefore, losses may only be used to offset against profits of the company that incurred them.

Mining income is subject to a royalty in addition to the general income tax. The royalty rate is based on annual sales of mining products, measured in metric tons of fine copper. Mining companies whose annual sales exceed 12,000 but are below 50,000 metric tons of fine copper are subject to a surtax ranging from 0.5 percent to 4.5 percent. Pursuant to recent legislation, the highest marginal rate applicable to annual sales exceeding 50,000 metric tons of fine copper is 14 percent.

Income taxes are generally levied through monthly income tax payments. Business entities that operate on a calendar year are required to file tax returns before April 30th of the following year. Chilean law does not provide for taxation on a consolidated basis.

B. International Aspects of Taxation in Chile

Outbound Taxation

Chilean residents are subject to income tax on their worldwide income. Chile's outbound rules apply the credit system whereby a foreign tax credit is generally used to offset double taxation arising from foreign income. The foreign tax credit is generally limited to the lesser of the Chilean business income tax (20 percent) or the foreign tax effectively paid. However, in the case of foreign dividend income and income from profit distributions, the credit is limited to the lesser of 30 percent of net foreign source income or the foreign tax effectively paid. In the case of dividends and profits distributions, an underlying tax credit is granted when the source country does not apply withholding tax or applies a withholding tax at a lower rate than the business income tax rate. Pensions received by Chilean residents from foreign countries are not considered income for Chilean tax purposes and are therefore exempt from tax.

Effective January 1, 2014,[9] an indirect foreign tax credit applies to taxes paid by subsidiaries of a company remitting profits to Chile. To be eligible for this credit, the foreign tax must be paid by a same-country direct or indirect subsidiary of the foreign company remitting profits to its Chilean parent. In addition, the company distributing the profits must hold, directly or indirectly, at least a 10 percent ownership of the same-country subsidiary. Regarding countries with which Chile has signed a tax treaty, the maximum foreign tax credit is increased from 30 percent to 35 percent.[10] With regard to countries that are not bound by a tax treaty with Chile, the maximum foreign tax credit is increased from 30 percent to 32 percent.[11] The excess amounts of foreign tax credit may be carried forward until they are fully exhausted.[12]

Inbound Taxation

Non-residents are generally subject to tax on Chilean-sourced income. Foreigners that establish residence in Chile are only liable for tax on the Chilean-source income during the first three years in the country. The general withholding rate payable on income paid to non-residents is 35 percent, although certain exceptions apply. A lesser withholding rate regime applies when a tax treaty has been concluded between Chile and the country in which the non-resident at issue resides. The 35 percent rate generally applies to income from services, dividends and other profit distributions. Previously paid business income tax on the underlying dividend is creditable against the non-resident income tax. The withholding rate is statutorily reduced to four percent on payments of certain interest, including interest paid on term deposits placed with an authorized financial institution in Chile, interest paid to finance imports, and interest on bonds

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9 Ley 20727 Introduce Modificaciones a la Legislación Tributaria en Materia de Factura Electrónica y Dispone Otras Medidas que Indica [Law 20727 Introducing Amendments to Tax Legislation on Electronic Invoice and Other Tax Measures] arts. 1–3, DIARIO OFICIAL [D.O.], Jan. 31, 2014, http://bcn.cl/1issk.

10 *Ibid*. art. 5.5.a.i.

11 *Ibid*. art. 5.4.d.

12 *Ibid*. art. 5.4.c.

issued by Chilean companies and/or the Chilean Treasury. Intellectual property income also benefits from reduced withholding rates; a 15 percent withholding rate applies to payments made to non-residents for the use of "discovery" patents, computer programs, industrial designs and sketches.[13] Director fees paid to non-residents are subject to a 20 percent withholding rate. A 30 percent withholding rate applies to royalty income consisting of trademarks, patents and formulas. Non-residents are subject to ordinary tax rules for capital gains sourced in Chile.

[13] However, the withholding rate is 30 percent if the said payments are made to related parties.

C. Other Taxes

Inheritance, gift and wealth taxes

Chile does not levy net wealth tax on individuals. Gifts and inheritances are subject to the Inheritance and Gift Tax (‘*Impuesto a las Herencias*’, ‘*Asignaciones y Donaciones*’). Chilean residents are subject to both inheritance and gift taxes. The taxable property consists of property of the decendent’s gross estate, or the specific gift received by the taxpayer. Certain allowances can be claimed depending on the recipient’s relationship with the decedent or donor. The actual tax rates are progressive and also depend on the taxpayer’s relationship with the decedent or donor.

Social security

Both employers and employees are subject to social security contributions. Employees are responsible for a 10-percent pension contribution and seven-percent health insurance contribution. Employers pay 1.49 percent for disability and life insurance. Additionally, both employers and employees pay for employment insurance; the employer contribution is 2.4 percent of an employee’s salary while the employee contribution is 0.6 percent of his salary (subject to annual limitations). Employers and employees may also be responsible for up to two percent of the salary for “heavy” work.

Value added tax

Chile imposes a 19-percent valued added tax (“VAT”). The VAT is levied on goods and services sold domestically. For imports, the taxable basis is the customs value, including customs duties. Certain goods and services are exempt or zero rated. Exports are zero rated, and the import of raw materials used in the production, processing or manufacturing of goods for export may be exempt from VAT.

Miscellaneous

A stamp duty applies to certain documents representing a debt claim, including promissory notes. The tax rate depends on the period of the loan and is based on the loan's capital, as specified in the document. The duty is 0.05 percent of the loan’s capital value for each month of the term, up to a maximum of 0.6 percent. Loans without a maturity date are subject to a 0.25 percent stamp duty.

The national government also levies and administers a property tax on real property. The current rates are 1.4 percent for real property situated in urban areas and one percent for rural properties.

IV. THE UNITED STATES AND CHILE: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

Tax treaties can be viewed as part of a set of economic arrangements, such as trade agreements and bilateral investment treaties, reached between two countries to promote cross-border economic activity. By clarifying the assignment of taxing authority between residence and source countries and eliminating the double-taxation of income, tax treaties reduce the uncertainty individuals and businesses may face when deciding to work or invest in another country and can increase after-tax returns to economic activity in cases where income may have been subject to double-taxation or withholding tax. Tax treaties can lead to a more efficient allocation of labor and capital between countries to the extent that they eliminate tax-related barriers to economic activity. However, their economic impact on individual countries depends on the character, and volume, of capital and labor outflows to a treaty country relative to capital and labor inflows from its treaty partner.

Tax treaties are often concluded between countries that already have significant economic ties and have historically preceded, rather than followed, trade agreements.[14] Although the literature on the economic impact of tax treaties is not extensive, research suggests that they have positive impacts on cross-border investment and trade.[15]

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[14] Peter Egger and George Wamser, "Multiple Faces of Preferential Market Access: Their Causes and Consequences," *Economic Policy*, vo. 28, no. 73, January 2013, pp. 143-187.

[15] *Ibid*.

B. Overview of Economic Activity Between the United States and Chile

Cross-border trade

Chile is the fifth largest economy in South America and is one of the more significant U.S. trading partners in the region. In 2013, the United States exported $17.6 billion worth of goods and services to Chile, making Chile the second largest destination for U.S. exports in South America and 19th largest in the world.[16] U.S. imports of goods and services from Chile totaled $10.4 billion in 2013, which made Chile the third largest source of U.S. imports from South America and 33rd largest source of imports from the world.[17] Trade between the United States and Chile has been facilitated by the United States-Chile Free Trade Agreement, which came into force in 2004. Chile is one of 20 countries in the world (and one of three countries in South America) where the United States has a free trade agreement in force.

Cross-border direct investment

In 2012, U.S. direct investment in Chile totaled $39.9 billion, and $3.5 billion in direct investment income was generated.[18] Chilean direct investment in the United States totaled $414 million in 2012, and $40 million in direct investment income was earned.[19]

Income taxes on cross-border income flows

Tax return data provide a complementary snapshot of the economic activity between the United States and Chile. For tax year 2010, Chilean-source gross income from U.S. corporate returns with a foreign tax credit totaled $5.0 billion, with $1.1 billion coming in the form of dividend income, $186 million arising from interest income, and $310 million generated from rents, royalties, and license fees.[20] Chilean taxes that were reported on these returns as paid, accrued, or deemed paid totaled $1.6 billion in 2010.[21]

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[16] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," http://www.bea.gov/international.

[17] *Ibid*.

[18] *Ibid*. Direct investment positions are valued on an historical-cost basis.

[19] The U.S. Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business.

[20] The data is obtained from Form 1118 filings. See http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-3.

[21] *Ibid*.

V. EXPLANATION OF PROPOSED TREATY

Article 1. General Scope

The proposed treaty generally applies only to residents of the United States and to residents of Chile, although certain provisions in the proposed treaty may apply to nonresidents of either treaty country, under the terms of the specific provision.[22] In addition, the scope of article 1 is addressed in the first four paragraphs of the proposed protocol, signed contemporaneously with the treaty. In its first paragraph, the proposed protocol provides a special rule regarding fiscally transparent entities that are identical to those in the U.S. Model treaty. The remaining paragraphs in the proposed protocol that pertain to Article 1 (General Scope) clarify the relationship of the proposed treaty with the other law of the treaty countries, including other international agreements to which either of them is a party. Thus, although the language of Article 1 of the proposed treaty is limited to language similar to that of the OECD Model, it is consistent in substance with the U.S. Model treaty by reason of the proposed protocol.

In limiting the general scope of the treaty to residents, Article 1 depends upon the definition of resident in Article 4 (Residence). That article provides that a person is a resident of a treaty country for purposes of the treaty if, under the laws of that treaty country, that person is be subject to the domestic tax laws on the basis of citizenship, residence, domicile, or similar criteria. The residency of a taxpayer who qualifies as a resident in both treaty countries under the general definition is determined by resort to a series of tiebreaker rules, including use of the mutual agreement procedures by the competent authorities.

Fiscally transparent entities

The proposed protocol provides that income derived through an entity that is fiscally transparent under the laws of either treaty country is considered to be the income of a resident of a treaty country only to the extent that such resident is treated under the tax laws of that treaty country as having derived the income. This provision parallels paragraph 6 of Article 1 (General Scope) of the U.S. Model treaty. The rule is needed because lack of symmetry between the definitions of fiscal transparency in the domestic laws of the treaty countries presents a risk of both double taxation and double nontaxation. The Technical Explanation identifies as the goals of the rule (1) the elimination of technical problems that may prevent investors in such entities from claiming treaty benefits and (2) prevention of the use of such entities to secure benefits in circumstances in which an investor is not subject to tax on the income in its country of residence.

The term "fiscally transparent" is not defined in the proposed treaty, proposed protocol or diplomatic notes, nor is it defined in the Code. The Technical Explanation adopts the description used in regulations promulgated to explain when treaty benefits may be denied with respect to payments received by or attributable to hybrid entities is offered. Under that regulation,[23] an

[22] These provisions may include Article 25(1) (Non-Discrimination) and Article 27 (Exchange of information), according to the Technical Explanation.

[23] Treas. Reg. sec. 1.894-1(d)(3).

entity is considered to be fiscally transparent under the laws of the jurisdiction of a holder of an interest in the entity to the extent that the laws in that jurisdiction require that a resident holder separately take into account on a current basis his respective share of the item of income paid to the entity, without regard to actual distribution to the interest holder. Character and source of the income in the hands of the interest holder are determined as if the income were realized directly by that interest holder. Examples of U.S. entities that would be considered fiscally transparent entities under this standard include partnerships, electing corporations under subchapter S of Chapter 1 of the Code ("S" corporations), common investment trusts under Code section 584, grantor trusts, and limited liability companies ("LLC") that are treated for tax purposes as a partnership or disregarded entity.

The Technical Explanation states that these rules for income derived through fiscally transparent entities apply regardless of the jurisdiction in which the entity is organized, including either of the treaty countries. The Technical Explanation also makes clear that these rules apply even if an entity organized in one treaty country is viewed differently under the tax laws of the other treaty country and provides an example of an entity organized under the laws of the United States that receives income from U.S. sources. If the entity is treated for Chilean tax purposes as a corporation, any owner who is a Chilean resident for Chilean tax purposes is not considered to have received the income directly. Even though the entity may be treated under the tax laws of the United States as fiscally transparent, it is the treatment of the Chilean resident under Chilean tax law that is determinative. Because the U.S. entity is not considered to be fiscally transparent under Chilean law, Chile would not require the owner to account for the income. Thus, for purposes of the proposed treaty, the income is treated as derived at the entity level. Similar results obtain if the putatively fiscally transparent entity is organized in a jurisdiction other than one of the treaty countries.

Proposed treaty interaction with domestic law or other U.S.-Chile agreement

Paragraph 2 of the proposed protocol provides the generally accepted rule that the proposed treaty does not restrict any benefit accorded by internal law or by any other agreement between the United States and Chile. Consequently, the proposed treaty may not increase the tax burden of a resident of either the United States or Chile beyond that determined under internal law.

Under the principles of paragraph 2, a taxpayer's U.S. tax liability need not be determined under the proposed treaty if the Code would produce a more favorable result. The Technical Explanation[24] states, however, that a taxpayer may not choose among the provisions of the Code and the proposed treaty in an inconsistent manner to minimize U.S. tax. The Technical Explanation includes an example illustrating this rule. In the example, a resident of Chile has three separate businesses in the United States. One is a profitable permanent establishment; the other two are trades or businesses that not meet the permanent establishment threshold tests of

[24] Department of the Treasury Technical Explanation of the Convention Between the Government of the United States of America and the Government of the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income (hereinafter referred to as the "Technical Explanation").

the proposed treaty. One is profitable and the other incurs a loss. Under the proposed treaty, the income of the permanent establishment is taxable in the United States, and both the income and loss of the other two businesses are ignored. Under the Code, all three would be subject to tax, but the loss would offset the income of the two profitable ventures. The Technical Explanation states that the taxpayer may not invoke the proposed treaty to exclude the income of the profitable trade or business and invoke the Code to claim the loss of the loss trade or business against the income of the permanent establishment. However, if the taxpayer invokes the Code for the taxation of all three ventures, that taxpayer would not be precluded from invoking the proposed treaty in respect of, for example, any dividend income from the United States that is not effectively connected with any of the taxpayer's business activities in the United States.

Proposed treaty interaction with the General Agreement on Trade in Services

Paragraph 3 of the proposed protocol specifically addresses the non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the "GATS") and its relationship to the proposed treaty. The provisions of paragraph 3 are an exception to the rule provided in paragraph 2 under which the proposed treaty may not restrict any benefit accorded by any other agreement between the United States and Chile.

Paragraph 3 provides that, unless the competent authorities determine that a taxation measure is not within the scope of Article 25 (Non-Discrimination) of the proposed treaty, the national treatment obligations of the GATS do not apply to that measure. For this purpose, the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action. Further, for purposes of paragraph 3 of Article XXII (Consultation) of the GATS, any question arising as to the interpretation or application of the proposed treaty, including whether a taxation measure is within the scope of the proposed treaty, is determined exclusively in accordance with the provisions of Article 26 (Mutual Agreement Procedure) of the proposed treaty. According to the Technical Explanation, the result under paragraph 3 of the proposed protocol is that paragraph 3 of Article XXII (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both treaty countries have determined that the relevant taxation measure is not within the scope of Article 25 (Non-Discrimination) of the proposed treaty.

Saving clause

Paragraph 4 of the proposed protocol adds a "saving clause" similar to paragraphs 4 and 5 of Article 1 (General Scope) of the U.S. Model treaty. Inclusion of the saving clause in the proposed protocol ensures that the scope of the treaty is consistent with all income tax treaties to which the United States is a party. Under the saving clause, both the United States and Chile are permitted to continue to tax their own citizens and residents, as if the treaty were not in force, subject to certain exceptions. As a result, citizens of either treaty country, regardless of residency, remain subject to tax under the laws of the treaty country in which they are citizens. However, because residence for purposes of the saving clause is determined under Article 4 (Residence) of the proposed treaty, a person who is a resident alien under U.S. domestic law but a resident of Chile under the tie-breaker provisions of the proposed treaty would not be subject to U.S. domestic law to the extent that such taxation would be inconsistent with the proposed treaty, according to the Technical Explanation.

The saving clause also permits a treaty country to tax, in accordance with its domestic laws, a former citizen or former long-term resident for a period of ten years following the loss of citizenship or long-term resident status. By so providing, the proposed treaty reconciles the saving clause with the United States statutory provisions for the imposition of tax on certain individuals who expatriated (that is, U.S. citizens and long-term residents who relinquish their citizenship or cease to be long-term residents). Expatriation prior to June 17, 2008 may result in taxation under in accordance with section 877, while later expatriations are may be taxed under the mark-to-market rules of section 877A. Regardless of the date of expatriation, similar definitions are used to determine whether a former citizen or long-term resident is subject to the special rules.

Under section 877, certain expatriates remain subject to U.S. tax for a period of ten years on both their U.S.-source income (including deemed U.S.-source income), and their foreign-source income that is effectively connected with the conduct of a trade or business within the United States. Persons who expatriated after that date are subject to the mark-to-market tax regime provided in section 877A, the imposition of which in turn depends upon definitions provided in section 877. The mark-to-market regime treats taxpayers who expatriate as having sold all of their property on the day before the expatriation date for its fair market value.[25] The time for payment of additional tax attributable to any gain so recognized (but not realized) may be deferred until the taxpayer actually disposes of property deemed sold, if the taxpayer elects to do so and irrevocably waives any right under any U.S. treaty that would preclude assessment or collection of the tax deferred by reason of the election.[26] Although section 877A may result in collection of the tax after the ten-year period permitted by the saving clause in the proposed treaty, the individual who elected to defer payment of the section 877A tax and sells property after the ten-year period, will have been required, as a condition of making the election, to waive the benefits of the proposed treaty's ten-year rule.

Exceptions to the saving clause preserve a number of benefits that the treaty accords to citizens and residents even though those persons would not be entitled to such benefits under domestic law. The following benefits conferred by the proposed treaty constitute the exceptions to the saving clause: the allowance of correlative adjustments when the profits of an associated enterprise are adjusted by the other country (Article 9, paragraph 2); exemption from source or resident state taxation for certain pension distributions and social security payments (Article 18, paragraphs 1.b), 3, 4, and 6); relief from double taxation through the provision of a foreign tax credit or an exemption for income earned in the other state (Article 23); protection of residents and nationals of one country from discriminatory tax treatment in the other country (Article 25); and benefits under the mutual agreement procedures of the proposed treaty (Article 26).

The saving clause also does not apply to certain benefits conferred by the United States or Chile upon individuals who are not citizens of, and have not been admitted for permanent residence in, the United States or Chile. Under this set of exceptions to the saving clause, the specified treaty benefits are available to, for example, a citizen of Chile who spends enough time

[25] Sec. 877A(a)(1).

[26] Secs. 877A(b)(1) and 877A(b)(5).

in the United States to be taxed as a U.S. resident but who has not acquired U.S. permanent residence status (that is, does not hold a "green card"). The benefits that are covered under this set of exceptions are exemptions from host country taxation for certain pension distributions and social security payments (Article 18, paragraphs 2 and 5), certain income from government service (Article 19), certain income received by visiting students and trainees or professors and teachers (Article 20), and certain income received by members of diplomatic missions and consular posts (Article 28).

The Technical Explanation also states that the treatment of fiscally transparent entities is not an exception to the saving clause. As a result, a treaty country is not precluded from taxing an entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with Chilean members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Chile views the LLC as fiscally transparent.

Article 2. Taxes Covered

For most purposes, the proposed treaty applies only to taxes imposed on the national level on income or capital, or any element of income or capital, irrespective of the manner in which the taxes are levied. Paragraph 2 of the article defines taxes on income or capital to include taxes on capital appreciation or gains from the alienation of property. A tax on capital includes a tax based on the value or ownership of a capital asset, such as property taxes, although such taxes are not imposed at the national level in either treaty country at present.

The existing taxes imposed by each treaty country that are subject to the treaty are identified in paragraph 3 of Article 2 of the proposed treaty. In the case of Chile, the proposed treaty applies to all taxes imposed under the Income Tax Act. With respect to U.S. taxes, the proposed treaty covers Federal income taxes imposed by the Code, excluding social security taxes, and Federal excise taxes imposed with respect to private foundations under Code sections 4940 through 4948. Unlike the U.S. Model treaty, it also covers unemployment taxes. Finally, in another departure from the U.S. Model treaty, U.S. excise taxes that are analogous to the Chilean income taxes on policies contracted with foreign insurers,[27] are covered.

Under paragraph 4 of Article 2, the proposed treaty also extends to certain taxes that are enacted after the treaty was signed, whether in addition to or replacing existing taxes. Eligible taxes include taxes on capital and any taxes that are identical or substantially similar to the covered taxes identified in paragraph 3 of Article 2. The competent authority of each treaty country is required to notify the competent authority of the other treaty country of any significant changes in its internal taxation laws. Both the notification requirement and the inclusion of later-enacted taxes are similar to the provisions of paragraph 4 of Article 2 (Taxes Covered) of the U.S. Model treaty.

[27] Taxes imposed with respect to insurance premiums paid to foreign insurers are limited under Article 7 (Business Profits).

Although Article 2 identifies which taxes are subject to the proposed treaty for most purposes, there are two instances in which the scope of covered taxes is broader, consistent with the U.S. Model treaty: non-discrimination claims and requests for exchange of information. With respect to requests for exchange of information under Article 27 (Exchange of Information), Article 2 is explicitly inapplicable. The Technical Explanation states that Article 27 applies to all taxes imposed at the national level. Taxes imposed by local or political subdivisions may not be the subject of a request to exchange information.

The application of Article 2 is also circumscribed with respect to nondiscrimination claims under Article 25 (Non-discrimination). Unlike requests under the exchange of information article, non-discrimination relief is available with respect to taxes imposed at the state and local level as well as national level. However, a tax imposed that was in force when the proposed treaty was signed, but was explicitly excluded from the scope of the proposed treaty, is not covered by the nondiscrimination provision. For example, U.S. social security taxes are not covered under Article 2, and are thus ineligible as a basis for a claim under Article 25 for relief from discrimination, as are any subsequently enacted social security taxes.

Article 3. General Definitions

This article defines a number of terms for purposes of the proposed treaty. Certain of the standard definitions found in most U.S. income tax treaties are included in the article.

The article sets forth the geographical scope of the proposed treaty with respect to Chile and the United States. In the case of Chile, it encompasses the territory of the Republic of Chile, including its territorial sea, and any area beyond the territorial sea within which the Republic of Chile, in accordance with international law, exercises sovereign rights with respect to the sea bed and subsoil of the submarine areas adjacent to the territorial sea. In the case of the United States, it encompasses the United States of America, including the States and the District of Columbia, and the territorial sea thereof. It also includes the sea bed and subsoil of submarine areas adjacent to the territorial sea, over which the United States exercises sovereign rights in accordance with international law. The term does not include Puerto Rico, the Virgin Islands, Guam, or any other U.S. possession.

The term “person” includes an individual, a company, and any other body of persons. The 2010 diplomatic notes provide that the term “person” includes an estate, trust, or partnership.

The term “company” means a body corporate or any entity treated as a body corporate for tax purposes in the state where it is organized.

The term “enterprise” applies to the carrying on of any business.

The terms “enterprise of a Contracting State” and “enterprise of the other Contracting State” mean, respectively, an enterprise carried on by a resident of a treaty country and an enterprise carried on by a resident of the other treaty country. The Technical Explanation clarifies that an enterprise of a treaty country need not be carried on in that treaty country. The 2010 diplomatic notes provide that an enterprise of a Contracting State also includes an enterprise conducted through an entity that is treated as fiscally transparent in the Contracting State where the entity's owner is resident.

The term "international traffic" means any transport by a ship or aircraft, except when such transport is solely between places within a treaty country. This definition is applicable principally in the context of Article 8 (International Transport).

The article designates the "competent authorities" for Chile and the United States. In the case of Chile, the competent authority is the Minister of Finance or his authorized representative. The U.S. competent authority is the Secretary of the Treasury or his delegate. According to the Technical Explanation, the Secretary of the Treasury has delegated the competent authority function to the Commissioner of Internal Revenue, who in turn has delegated authority to the Deputy Commissioner (International) Large Business and International ("LB&I").

The term "national," as it relates to one of the United States and to Chile, means (1) an individual who is a citizen or national of that State, and (2) any legal person, partnership, or association deriving its status as such from the laws in force in the State where it is established.

The term "pension fund" means any person established in a treaty country that is (1) generally exempt from income taxation in that country and (2) operates principally to administer or provide pension or retirement benefits or to earn income for the benefit of one or more such persons.

Terms that are not defined in the proposed treaty are covered in paragraph 2. Paragraph 2 provides that in the application of the proposed treaty, any term not defined in the proposed treaty will have the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise or the competent authorities have agreed on a different meaning under Article 26 (Mutual Agreement Procedure). If the term is defined under both the tax and non-tax laws of a treaty country, the definition of the tax law prevails.

Article 4. Residence

The assignment of a country of residence is important because the benefits of the proposed treaty generally are available only to a resident of one of the treaty countries as that term is defined in the proposed treaty. Issues arising because of dual residency, including situations of double taxation, may be avoided by the assignment of one treaty country as the country of residence when under the internal laws of the treaty countries a person is a resident of both countries.

Internal taxation rules

United States

Under U.S. law, the residence of an individual is important because a resident alien, like a U.S. citizen, is taxed on his or her worldwide income, while a nonresident alien is taxed only on certain U.S.-source income and on income that is effectively connected with a U.S. trade or business. An individual who spends sufficient time in the United States in any year or over a three-year period generally is treated as a U.S. resident. A permanent resident for immigration purposes (that is, a "green card" holder) also is treated as a U.S. resident.

Under U.S. law, a company is taxed on its worldwide income if it is a "domestic corporation." A domestic corporation is one that is created or organized in the United States or under the laws of the United States, a State, or the District of Columbia.

Chile

An individual is generally a resident of Chile if the individual is present in Chile for a period greater than six months in a given calendar year or in any given two calendar years.

A company is considered to be resident in Chile if it is incorporated in Chile.

Proposed treaty rules

Article 4 provides rules to determine whether a person is a resident of the United States or Chile under the proposed treaty. The rules are generally consistent with the rules of the U.S. Model treaty.

The proposed treaty generally defines "resident of a Contracting State" to mean any person who, under the laws of that State, is liable to tax in that State by reason of the person's domicile, residence, citizenship, place of management, place of incorporation, or any other criterion of a similar nature. The Technical Explanation notes that this definition generally incorporates the definitions of residence in the tax laws of the United States and Chile. Residents of the United States under this definition include aliens who are considered U.S. residents under the substantial presence and green card tests of the Code.

According to the Technical Explanation, certain entities such as U.S. regulated investment companies ("RICs") and real estate investment trusts ("REITs") are residents of the United States for purposes of the proposed treaty even though those entities are rarely required to pay tax. The Technical Explanation notes that these entities are taxable to the extent they do not satisfy certain requirements for distributing their profits currently and, consequently, that they may be considered "liable to tax" in the United States.

The term "resident of a Contracting State" does not include any person who is liable to tax in that State only in respect of income from sources in that State or of capital situated in that State. Under paragraph 3 of the 2010 diplomatic notes, the term "resident of a Contracting State" does not include a person who is liable to tax in that State only on profits attributable to a permanent establishment in that State. Consequently, according to the Technical Explanation, a consular official of Chile posted in the United States is not a resident of the United States because under the Code the official may be taxed by the United States on his U.S.-source investment income but not on his non-U.S. source income. Similarly, an enterprise of Chile with a permanent establishment in the United States does not become a resident of the United States as a result of its U.S. permanent establishment: The enterprise generally is liable to tax by the United States only on income attributable to its U.S. permanent establishment, not on its worldwide income, as it would be if it were a U.S. resident.

The proposed treaty includes in the definition of "resident of a Contracting State" the government of that State and any political subdivision, local authority, agency, or instrumentality of that State.

Paragraph 6 of the proposed protocol provides that the term "resident of a Contracting State" includes a pension fund established in that State and an organization that is established and maintained in that State exclusively for religious, charitable, educational, scientific or other similar purpose. The latter sort of organization and pension funds may qualify as treaty country residents even though all or a part of their income or gains may be exempt from tax under domestic law.

Paragraph 7 of the proposed protocol provides that Chile will treat a U.S. citizen or an alien lawfully admitted for permanent residence in the United States (a green card holder) as a resident of the United States only if that individual has a substantial presence, permanent home, or habitual abode in the United States and only if that individual is not a resident of a country other than Chile for the purposes of a bilateral income tax treaty between that country and Chile.

The proposed treaty provides a series of tie-breaker rules to determine the residence of an individual who, under the basic residence definition, would be considered to be a resident of both countries. These tie-breaker rules are to be applied in the order in which they are set forth in the proposed treaty and described below. An individual is deemed to be a resident of the country in which he or she has a permanent home available. If the individual has a permanent home in both treaty countries, the individual's residence is deemed to be the country with which his or her personal and economic relations are closer (that is, the individual's "center of vital interests"). If it cannot be determined in which country the individual has his or her center of vital interests, or if the individual does not have a permanent home available in either treaty country, the individual is deemed to be a resident of the country in which he or she has a habitual abode. If the individual has a habitual abode in both countries or in neither country, the individual is deemed to be a resident of the country of which he or she is a national. If the individual is a national of both countries or of neither country, the competent authorities of the countries will settle the question of residence by mutual agreement.

The proposed treaty does not include the U.S. Model treaty tie-breaker rule for a company that under the treaty's general residence rule is a resident of both countries (a "dual resident company"). Under that U.S. Model treaty rule, a dual resident company that is created or organized under the laws of one treaty country or a political subdivision of that country but not under the laws of the other treaty country or a political subdivision of that other country is treated as a resident of the former treaty country. Although the proposed treaty does not include this tie-breaker rule for dual resident companies, it does include a related rule found in the U.S. Model treaty and other U.S. tax treaties. That rule is that if, under the general residence rule described previously, a person other than an individual (such as a company, a trust, or an estate) is a resident of both treaty countries, the competent authorities of the treaty countries must endeavor to determine by mutual agreement the mode of application of the proposed treaty to that person. If the competent authorities are unable to agree that such a person is a resident of one country or the other, the person will not be treated as a resident of either country for purposes of its claiming benefits provided by the proposed treaty other than benefits under Article 26 (Mutual Agreement Procedure).

According to the Technical Explanation, a dual resident company the residence of which is not agreed upon by the competent authorities may be treated as a resident of a treaty country for purposes other than obtaining benefits under the proposed treaty. For example, according to the Technical Explanation, if a dual resident company pays a dividend to a resident of Chile, the dual resident company is treated as a resident of the United States for purposes of the proposed treaty and U.S. withholding tax on the dividend is limited to the treaty rate because the treaty reduction is a benefit of the resident of Chile, not a benefit of the dual resident company. The Technical Explanation also provides that information related to dual resident companies may be exchanged because Article 27 (Exchange of Information) is not limited to residents of the treaty countries.

Article 5. Permanent Establishment

The proposed treaty contains a definition of the term "permanent establishment" that generally follows the language of other recent U.S. income tax treaties, the U.S. Model treaty, and the OECD Model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether these items of income will be taxed as business profits.

In general, under the proposed treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction or exploitation of natural resources. It also includes an installation used for the on-land exploration of natural resources if the activity continues for more than three months, a building site or a construction or installation 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, and an enterprise that performs services for a period exceeding 183 days in any 12-month period if the services are performed through one or more individuals who are present and performing services in the country. The Technical Explanation adopts the OECD Commentary to Article 5 that in determining whether a permanent establishment exists, the place of business must be "fixed" in the sense that a particular building or physical location is used by the enterprise for the conduct of its business, and that it is foreseeable that this use will be more than temporary. The list of types of fixed places of business that constitute a permanent establishment is an illustrative list and non-exclusive.

The Technical Explanation provides guidance related to the determination of whether a building site or a construction, assembly or installation project, or an installation or drilling rig or ship used for the exploration of natural resources constitutes a permanent establishment for the contractor, driller, etc. It also clarifies the distinction between exploration and exploitation of natural resources - although the drilling of an oil rig within a two-month time period does not constitute a permanent establishment, once production begins the well itself is a permanent establishment. The Technical Explanation states that time spent by a sub-contractor on a building site is counted as time spent by the general contractor for purposes of determining if the general contractor has a permanent establishment, but for the sub-contractor itself to have a permanent establishment the sub-contractor's activities at the site must last for more than 12 months. If a sub-contractor is on a site intermittently, time is measured from the first day the sub-contractor is on the site until the last day he is on the site (*i.e.*, intervening days are counted). The time limits apply separately to each installation, site or project, as the case may be. If the relevant time limit is exceeded, the installation, site or project constitutes a permanent establishment from the first day of activity.

Additionally, the Technical Explanation clarifies that the 183-day rule applies only to services of an enterprise resident in one treaty country that are performed in the other treaty country. For example, customer support or other services performed in one treaty country by telephone or computer to customers located in the other country are not covered by this rule because the services are not performed in the other country. By deeming the enterprise to provide services through a permanent establishment in the other treaty country, the treaty allows the application of Article 7 (Business Profits), resulting in net basis taxation of the services. Such taxation is also limited to the profits attributable to the activities carried on in performing the relevant services.

The proposed treaty provides that the following activities of a preparatory or auxiliary character are deemed not to constitute a permanent establishment: (1) the use of facilities solely for storing, displaying, or delivering goods or merchandise belonging to the enterprise; (2) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for storage, display, or delivery; (3) the maintenance of a stock of goods or merchandise belonging to the enterprise solely for the purpose of processing by another enterprise; (4) the maintenance of a fixed place of business solely for the purpose of purchasing goods or merchandise, or of collecting information for the enterprise; and (5) the maintenance of a fixed place of business solely for the purpose of advertising, supplying information or carrying out scientific research for the enterprise. The proposed treaty also provides that the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character does not constitute a permanent establishment.

Under the proposed treaty, if a person, other than an independent agent, is acting in a treaty country on behalf of an enterprise and has, and habitually exercises, the authority to conclude contracts that are binding on the enterprise, the enterprise is deemed to have a permanent establishment in respect of any activities undertaken for that enterprise. This rule does not apply in cases in which the activities are limited to the activities described in the preceding paragraph that would not give rise to a permanent establishment if carried on by the enterprise through a fixed place of business.

The Technical Explanation clarifies that although the proposed treaty uses the U.S. Model language "binding on the enterprise," rather than the OECD Model language "in the name of that enterprise," this difference is not intended to be a substantive difference. As indicated in the OECD Commentaries on Article 5, paragraph 5, the Article is intended to encompass persons who have "sufficient authority to bind the enterprise's participation in the business activity in the State concerned."

No permanent establishment is deemed to arise under the proposed treaty if the agent is a broker, general commission agent, or any other agent of independent status, provided that the agent is acting in the ordinary course of its business as an independent agent. Paragraph 8 of the proposed protocol clarifies that to fall within this provision, a person must be independent of the enterprise both legally and economically, and must act in the ordinary course of the person's business when acting on behalf of the enterprise.

The Technical Explanation further clarifies that the whether the agent and the enterprise are independent is a factual determination. An agent that is subject to detailed instructions regarding the conduct of its operations, or comprehensive control by the enterprise is not legally independent. The extent to which the agent bears business risk is a relevant factor. An agent that bears little or no risk from the activities it performs is not economically independent. The exclusivity of the agent is also a relevant factor in determining whether an agent is economically independent from the enterprise.

Under the proposed treaty, the fact that a company that is a resident of one country controls or is controlled by a company that is a resident of the other country or that carries on business in the other country does not cause either company to be a permanent establishment of the other. Whether a company is a permanent establishment of a related company is based solely on the factors described above, and not on the ownership or control relationship between the companies.

Article 6. Income from Real Property (Immovable Property)

This article covers income from real property (also referred to in the proposed treaty as immovable property). The rules governing gains from the sale of real property are included in Article 13 (Capital Gains). Under the proposed treaty, income derived by a resident of one country from real property situated in the other country, including income from agriculture or forestry, may be taxed in that other country. The Technical Explanation notes that the proposed treaty does not grant an exclusive taxing right to the country in which the property is situated; that country is merely given the primary right to tax. These general rules and, in general, the other rules of this article are consistent with the rules in the U.S. and OECD Model treaties.

The Technical Explanation also notes that the proposed treaty does not limit the rate or form of tax that the country in which real property is located (the source country) may impose on income from that real property derived by a resident of the other treaty country, except that the source country must permit the net-basis taxation election described below.

The term "real property" generally has the meaning that it has under the law of the country in which the property in question is situated.[28] The proposed treaty provides that, regardless of internal law definitions, real property also includes property accessory to real property; livestock and equipment used in agriculture and forestry; rights to which the provisions of general law respecting landed property apply; usufruct of real property; and rights to variable

[28] In the case of the United States, according to the Technical Explanation, the term "real property" has the meaning given to it by Treas. Reg. sec. 1.897-1(b).

or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources, and other natural resources. Ships, aircraft, and containers are not regarded as real property.

The proposed treaty provides that the country in which the property is situated also may tax income derived from the direct use, letting, or use in any other form of the real property.

The rules permitting source-country taxation of income from real property also apply to the income from real property of an enterprise and to income from real property used for the performance of independent personal services. This rule, according to the Technical Explanation, clarifies that the source may tax the real property income of a resident of the other treaty country even if the income is not attributable to that resident's permanent establishment or fixed base in the source country. This rule is an exception to the general rules in Articles 7 (Business Profits) and 14 (Independent Personal Services) that income is taxable in the source country only if it is attributable to a permanent establishment or fixed base in that country.

Under paragraph 9 of the proposed protocol, a resident of one treaty country that derives real property income from the other treaty country and that is not otherwise permitted to compute the source-country tax on the income may elect for any taxable year to be subject to net-basis taxation by the source country on the real property income as if the income were attributable to a permanent establishment in the source country. This election is binding for the taxable year of the election and all subsequent taxable years unless the competent authority of the source country agrees to terminate the election.[29]

The 2011 diplomatic notes correct a typographical error in the header of paragraph 9 of the proposed protocol. The header of that paragraph 9 should refer only to Article 6, not to paragraph 5, of Article 6.

Article 7. Business Profits

Internal taxation rules

United States

U.S. law distinguishes between the U.S. business income and the other U.S. income of a non-resident alien or foreign corporation. A non-resident alien or foreign corporation is subject to a flat 30-percent rate (or lower treaty rate) of tax on certain U.S. source income if that income is not effectively connected with the conduct of a trade or business within the United States. The regular individual or corporate rates apply to income (from any source) that is effectively connected with the conduct of a trade or business within the United States. The performance of personal services within the United States may constitute a trade or business within the United States.

[29] According to the Technical Explanation, termination of an election will be granted in accordance with the provisions of Treas. Reg. sec. 1.871-10(d)(2).

The treatment of income as effectively connected with a U.S. trade or business depends upon whether the source of the income is U.S. or foreign. In general, U.S. source periodic income (such as interest, dividends, rents, and wages) and U.S. source capital gains are effectively connected with the conduct of a trade or business within the United States if the asset generating the income is used in (or held for use in) the conduct of the trade or business or if the activities of the trade or business are a material factor in the realization of the income. All other U.S. source income of a person engaged in a trade or business in the United States is treated as effectively connected with the conduct of a trade or business in the United States (under what is referred to as a "force of attraction" rule).

The income of a non-resident alien individual from the performance of personal services within the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Foreign source income generally is effectively connected income only if the foreign person has an office or other fixed place of business in the United States and the income is attributable to that place of business. In those circumstances, only three types of foreign source income are considered to be effectively connected income: rents and royalties for the use of certain intangible property derived from the active conduct of a U.S. business; certain dividends and interest either derived in the active conduct of a banking, financing or similar business in the United States or received by a corporation the principal business of which is trading in stocks or securities for its own account; and certain sales income attributable to a U.S. sales office. Special rules apply for purposes of determining the foreign source income that is effectively connected with a U.S. business of an insurance company.

Any income or gain of a foreign person for any taxable year that is attributable to a transaction in another year is treated as effectively connected with the conduct of a U.S. trade or business if it would have been so treated had it been taken into account in that other year (section 864(c)(6)). In addition, if any property ceases to be used or held for use in connection with the conduct of a trade or business within the United States, the determination of whether any income or gain attributable to a sale or exchange of that property occurring within ten years after the cessation of business is effectively connected with the conduct of a trade or business within the United States is made as if the sale or exchange occurred immediately before the cessation of business (section 864(c)(7)).

An excise tax is imposed on insurance premiums paid to a foreign insurer or reinsurer with respect to U.S. risks. The rate of tax is either four percent or one percent. The rate of the excise tax is four percent of the premium on a policy of casualty insurance or indemnity bond that is (1) paid by a U.S. person on risks wholly or partly within the United States, or (2) paid by a foreign person on risks wholly within the United States. The rate of the excise tax is one percent of the premium paid on a policy of life, sickness or accident insurance, or an annuity contract. The rate of the excise tax is also one percent of any premium for reinsurance of any of the foregoing types of contracts. The excise tax paid by one party cannot be credited if, for example, the risk is reinsured with a second party in a transaction that is also subject to the excise tax.

Two exceptions to the application of the insurance excise tax are provided. One exception is for amounts that are effectively connected with the conduct of a U.S. trade or business (provided no treaty provision exempts the amounts from U.S. taxation). Thus, under this exception, the insurance excise tax does not apply to amounts that are subject to U.S. income tax in the hands of a foreign insurer or reinsurer pursuant to its election to be taxed as a domestic corporation under section 953(d), or pursuant to its election under section 953(c) to treat related person insurance income as effectively connected to the conduct of a U.S. trade or business. The other exception applies to premiums on an indemnity bond to secure certain pension and other payments by the United States government.

Chile

Non-residents are generally subject to tax on Chilean-sourced income. The general withholding rate payable on income paid to non-residents is 35 percent, although certain exceptions apply. A lesser withholding rate regime applies when a tax treaty has been concluded between Chile and the country in which the non-resident at issue resides. The 35-percent rate generally applies to income from services, dividends and other profit distributions. Note that previously paid business income tax on the underlying dividend is creditable against the non-resident income tax. The withholding rate is statutorily reduced to four percent on payments of certain interest, including interest paid on term deposits placed with an authorized financial institution in Chile, interest paid to finance imports, and interest on bonds issued by Chilean companies and/or the Chilean Treasury.

Intellectual property income also benefits from reduced withholding rates: a 15-percent withholding rate applies to payments made to non-residents for the use of "discovery" patents, computer programs,[30] industrial designs and sketches, and new vegetable patents.[31] A 30-percent withholding rate applies to royalty income from trademarks, patents, formulas, and similar items. Payments made to non-resident producers or distributors for material to be shown in cinemas or television are subject to a 20-percent withholding rate, while payments for the use of copyrights or authors' rights on books are subject to a 15-percent withholding rate.

Payments made to non-residents for engineering and technical work and for professional and technical services resulting in advice, a report, or a plan are subject to a 15-percent withholding rate.[32]

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[30] However, payments made to non-residents for the use of standard software (e.g., shrink-wrapped software) are exempt from withholding tax.

[31] However, the withholding rate is 30 percent if the said payments are made to related parties and/or if the non-resident resides in a tax haven jurisdiction as identified by the Chilean treasury.

[32] However, the withholding rate is 20 percent if the said payments are made to related parties and/or if the non-resident resides in a tax haven jurisdiction as identified by the Chilean treasury.

Non-residents are generally subject to ordinary tax rules for capital gains sourced in Chile.

Insurance premiums paid to non-resident insurers are subject to a 22 percent withholding rate, while reinsurance premiums paid to non-resident reinsurers are subject to a 2 percent withholding rate.

<u>Proposed treaty limitations on internal law</u>

Under the proposed treaty, business profits of an enterprise of a treaty country may be taxed in the other treaty country only to the extent that they are attributable to a permanent establishment in that other country through which the enterprise carries on business. This rule is one of the basic treaty limitations on a country's right to tax income of a resident of the other country. The rule is similar to the rules found in the U.S. and OECD Model treaties.

Paragraph 9 of the proposed treaty defines the term "business profits" as the income from any trade or business. The term "business profits" thus includes income attributable to notional principal contracts and other financial instruments to the extent that the income is attributable to a trade or business of dealing in such instruments or is otherwise related to a trade or business (as in the case of a notional principal contract entered into for the purpose of hedging currency risk arising from an active trade or business). Any other income derived from financial instruments is, according to the Technical Explanation, addressed in Article 21 (Other Income) unless it is specifically governed by another article.

The Technical Explanation states that the term "business profits" also includes income earned by an enterprise from the furnishing of personal services. The inclusion in business profits of income of an enterprise from personal services is consistent with the long-standing U.S. position that an enterprise's personal services income is business profits. Accordingly, a consulting firm resident in one treaty country whose employees or partners perform services in the other treaty country through a permanent establishment may be taxed in that other country on a net basis under Article 7, not under Article 15 (Dependent Personal Services), because Article 15 applies only to income of employees.

In addition, the Technical Explanation states that business profits include income derived by a partner of one treaty country that is attributable to personal services performed in the other country through a partnership with a permanent establishment in that other country. Thus, in the case of a partner in a service partnership, the partner's income attributable to the permanent establishment in respect of the performance of the personal services carried on by the partnership (whether by the partner himself, other partners in the partnership, or by employees assisting the partners), as well as any income from activities that are ancillary to the performance of the services (*e.g.*, charges for facsimile services), is taxed under Article 7, not under Article 14 (Independent Personal Services). For example, if a Chile partnership has four resident partners who perform personal services only in the Chile office and one non-resident partner who performs personal services in a U.S. office that is a permanent establishment in the United States (and the five partners agree to equally split profits), the four Chile resident partners may be taxed in the United States with respect to their shares of the income that is attributable to the U.S. office. The services that generate the income attributable to the U.S. office would include the services performed by the partner resident in the U.S. office, as well as any income with respect to services performed by a visiting partner who travels to the United States and performs such services in the United States, regardless of whether the visiting partner actually visited or used the U.S. office while performing the services in the United States.

The proposed treaty provides rules for the attribution of business profits to a permanent establishment. Under these rules, the treaty countries attribute to a permanent establishment the business profits that the permanent establishment might be expected to make if it were a distinct and separate enterprise engaged in the same or similar activities under the same or similar conditions and dealing wholly independently with the enterprise of which it is a permanent establishment. The Technical Explanation states that this language incorporates the arm's-length standard for purposes of determining the business profits attributable to a permanent establishment. For this purpose, the business profits to be attributed to the permanent establishment include only the profits derived from the assets used and activities performed by the permanent establishment (consistent with the "asset-use" and "business activities" tests of section 864(c)(2)).

The Technical Explanation indicates that the concept of "attributable to" is an alternative to the analogous but somewhat different effectively connected income concept of section 864(c). According to the Technical Explanation, the profits attributable to a permanent establishment may be from sources within or without a Contracting State.

The proposed treaty provides that in computing the business profits of a permanent establishment, deductions are allowed for necessary expenses, wherever incurred, that are for the purposes of the permanent establishment. These deductions include a reasonable allocation of executive and general administrative expenses, research and development expenses, interest, and other expenses so incurred. The Technical Explanation states that deductions are allowed regardless of which accounting unit of the enterprise books the expenses, so long as the expenses are incurred for the purposes of the permanent establishment (including for the purposes of the enterprise as a whole or that part of the enterprise that includes the permanent establishment). This rule permits (but does not require) a treaty country to apply the type of expense allocation rules provided by U.S. law (such as in Treas. Reg. sections 1.861-8 and 1.882-5). However, the proposed treaty does not permit a deduction for expenses charged to a permanent establishment by another unit of the enterprise.

Like the U.S. and OECD Model treaties, the proposed treaty provides that business profits are not attributed to a permanent establishment merely by reason of the purchase of goods or merchandise by the permanent establishment for the enterprise of which it is a part. According to the Technical Explanation, this rule applies only to an office that performs functions in addition to purchasing because purchasing does not by itself give rise to a permanent establishment under Article 5 (Permanent Establishment) to which income can be attributed. When it applies, the rule provides that business profits may be attributable to a permanent establishment for its non-purchasing activities (*e.g.*, sales activities), but not for its purchasing activities.

The proposed treaty requires that the determination of the business profits of a permanent establishment be made using the same method year by year unless there is good and sufficient reason to the contrary. The Technical Explanation states that this rule limits the ability of both the treaty country and the enterprise to change accounting methods to be applied to the permanent establishment.

The proposed treaty provides that, notwithstanding the provisions of Article 7, paragraph 1, in the absence of a permanent establishment, the United States may impose its excise tax on insurance premiums paid to foreign insurers, and Chile may impose its tax on payments for insurance policies contracted with foreign insurers. However, notwithstanding the provisions of Article 2 (Taxes Covered), the tax so charged shall not exceed two percent of the gross amount of reinsurance premiums and five percent of the gross amount of all other insurance premiums.

Under present U.S. domestic law, the U.S. insurance excise tax does not apply to amounts that are effectively connected to a U.S. trade or business, including income from a U.S. permanent establishment of a foreign insurer or reinsurer. Further, the applicable rates of the U.S insurance excise tax (*i.e.*, one percent for reinsurance premiums and four percent for all other insurance premiums) are below the maximum rates of tax set forth in the proposed treaty for each category of insurance premiums (*i.e.*, two percent for reinsurance premiums and five percent for all other insurance premiums). Thus, the proposed treaty provides for the same result as present U.S. domestic law, but reduces the withholding rate that Chile may impose on non-resident insurers from 22 percent to five percent.[33]

Where business profits include items of income that are dealt with separately in other articles of the proposed treaty, those other articles, and not the business profits article, generally govern the treatment of those items of income. Thus, for example, the taxation of dividends is determined under the rules of Article 10 (Dividends), and not by the rules of Article 7, except as specifically provided in Article 10 (that is, when dividends are attributable to a permanent establishment). Similarly, Article 7 does not apply to income derived from shipping and air transport activities in international traffic, which is governed by Article 8 (Shipping and Air Transport).

The proposed treaty provides that, for purposes of the taxation of business profits, income may be attributable to a permanent establishment (and therefore may be taxable in the source country) even if the payment of the income is deferred until after the permanent establishment has ceased to exist. This rule incorporates into the proposed treaty the rule of section 864(c)(6) described in the summary of U.S. internal law above. This rule applies for purposes of the rules for business profits under this article, dividends (Article 10, paragraph 5), interest (Article 11, paragraph 6), royalties (Article 12, paragraph 4), capital gains (Article 13, paragraph 3), independent professional services (Article 14, paragraph 2), and other income (Article 21, paragraph 2).

The Technical Explanation notes that Article 7 is subject to the saving clause of paragraph 4 of the proposed protocol. Thus, if a U.S. citizen who is a resident of Chile derives business profits from the United States that are not attributable to a permanent establishment in

[33] The withholding rate that Chile may impose on non-resident reinsurers remains at two percent under the proposed treaty.

the United States, the United States may, subject to the special foreign tax credit rules of paragraph 3 of Article 23 (Relief from Double Taxation), tax those profits, notwithstanding that paragraph 1 of this article would exempt the income from U.S. tax.

The Technical Explanation further notes that Article 7 is subject to Article 24 (Limitation on Benefits). Consequently, a Chilean enterprise with income that is effectively connected to a U.S. trade or business is not entitled to the benefits of Article 7 unless the resident carrying on the enterprise qualifies for those benefits under Article 24.

Article 8. International Transport

Article 8 of the proposed treaty covers income from the operation of ships and aircraft in international traffic. The rules governing income from the disposition of ships, aircraft, and containers operated or used in international traffic are in paragraph 4 of Article 13 (Capital Gains).

The proposed treaty provides that profits of an enterprise of one treaty country from the operation of ships or aircraft in international traffic are taxable only in that country. Paragraph 6 of Article 7 (Business Profits) provides that if profits include items of income that are described in both Article 7 and other articles of the proposed treaty, including Article 8, the provisions of those other articles are not affected by the provisions of Article 7. The rules of Article 8, therefore, are not affected by the general rule of Article 7 that profits attributable to a permanent establishment that an enterprise of a treaty country has in the other treaty country may be taxed in the other treaty country. Consequently, the profits of an enterprise of a treaty country from the operation of ships or aircraft in international traffic may not be taxed in the other treaty country even if the enterprise has a permanent establishment in that other treaty country.

"International traffic" is defined in Article 3(1)(g) (General Definitions) as any transport by a ship or aircraft, except when the transport is solely between places in a treaty country.

The proposed treaty provides that profits from the operation of ships or aircraft in international traffic include profits derived from the rental of ships or aircraft on a full basis (that is, rental with crew, whether on a time or voyage basis). By contrast with the U.S. Model treaty, the proposed treaty includes in the scope of profits from the operation of ships or aircraft in international traffic an enterprise's profits from the charter or rental of ships or aircraft on a bareboat basis (that is, without crew) only if those profits are incidental to the enterprise's profits from the operation of ships or aircraft in international traffic. Consequently, unlike under the U.S. Model treaty, if an enterprise's profits from bareboat rentals are not incidental to profits from that enterprise's operation of ships or aircraft in international traffic, the profits from the bareboat rentals constitute business profits and are taxed in accordance with the provisions of Article 7 (Business Profits).

Under paragraph 11 of the proposed protocol, inland transport within either Chile or the United States is treated as the operation of ships or aircraft in international traffic if the inland transport is undertaken as part of transport that includes transport by ships or aircraft in international traffic. Thus, according to the Technical Explanation, if a U.S. shipping company contracts to carry property from Chile to a U.S. city and as part of that contract transports the property by truck from its point of origin to an airport in Chile (or contracts with a trucking company to carry the property to the airport), the income earned by the U.S. shipping company from the overland leg of the transport is taxable only by the United States. Similarly, the Technical Explanation states that Article 8 also applies to all income derived from a contract for the international transport of goods even if the goods are transported to the port by a lighter (a barge used in loading and unloading ships) and not by the vessel that carries the goods in international waters.

The proposed treaty provides that profits of an enterprise of a treaty country from the use, maintenance, or rental of containers (including related equipment for the transport of those containers) used for the transport of goods or merchandise in international traffic are taxable only in that treaty country. According to the Technical Explanation, this exclusive residence country taxation applies even if the enterprise is not engaged in the operation of ships or aircraft in international traffic and even if the enterprise has a permanent establishment in the other treaty country.

As under the U.S. Model treaty, the shipping and air transport provisions of the proposed treaty apply to profits from participation in a pool, a joint business, or an international operating agency. These arrangements are common methods of cooperation among international shipping and air transport companies.

The Technical Explanation notes that Article 8 is subject to the saving clause (added by paragraph 4 of the proposed protocol) of Article 1 (General Scope). Consequently, if a U.S. citizen who is a resident of Chile derives profits from the operation of ships or aircraft in international traffic, the United States may tax those profits as part of the citizen’s worldwide income (subject to the proposed treaty’s foreign tax credit rules). The benefit of exclusive residence country taxation is available to an enterprise of a treaty country only if that enterprise satisfies the limitation on benefits requirements of Article 24.

Article 9. Associated Enterprises

The proposed treaty, like most other U.S. tax treaties, contains an arm’s-length pricing provision. The proposed treaty recognizes the right of each country to make an allocation of profits to an enterprise of that country in the case of transactions between related enterprises, if conditions are made or imposed between the two enterprises in their commercial or financial relations that differ from those that would be made between independent enterprises. In such a case, a country may allocate to such an enterprise the profits that it would have accrued but for the conditions so imposed. This treatment is consistent with the U.S. Model treaty provision.

For purposes of the proposed treaty, an enterprise of one country is related to an enterprise of the other country if one of the enterprises participates directly or indirectly in the management, control, or capital of the other enterprise. Enterprises are also related if the same persons participate directly or indirectly in the enterprises’ management, control, or capital.

Under the proposed treaty, when a redetermination of tax liability has been made by one country under the provisions of this article, and the other country agrees with that redetermination, then that other country will make an appropriate adjustment to the amount of tax paid in that country on the redetermined income. In making such adjustment, due regard is to be given to other provisions of the proposed treaty. The proposed treaty's saving clause retaining full taxing jurisdiction in the country of residence or citizenship does not apply in the case of such adjustments. Accordingly, internal statute of limitations provisions do not prevent the allowance of appropriate correlative adjustments. However, the Technical Explanation states that statutory or procedural limitations cannot be overridden to impose additional tax because paragraph 2 of the proposed protocol provides that the proposed treaty may not restrict any statutory benefit.

Article 10. Dividends

Overview

The dividends article of the proposed treaty generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed treaty includes a generally applicable maximum rate of withholding at source of 15 percent and a reduced five-percent maximum rate for dividends received by a company owning at least 10 percent of the dividend-paying company. A zero rate of withholding tax generally applies to dividends received by pension funds if the dividends are not derived from the trade or business by the pension fund or through an associated enterprise. The proposed treaty also provides rules for the imposition of tax on branch profits and prohibits one country from imposing taxes on a company resident in the other country, other than a branch profits tax, on undistributed earnings.

Some of the provisions in this article are generally consistent with the U.S. and OECD model treaties, although the proposed treaty does not provide the complete exemption from withholding tax for certain direct dividends as is found in a number of recent U.S. tax treaties and protocols. Additionally the proposed treaty includes special rules on taxation of undistributed earnings and does not include special rules for dividends from RICs and REITs that is found in a number of recent U.S. tax treaties and protocols.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a

30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[34] Such distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a gain from the disposition of a U.S. real property interest that must be recognized by a nonresident alien individual or a foreign corporation to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[35]

REITs generally are organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through to the REIT's shareholders the interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as a corporation subject to corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders

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[34] Because a REIT generally does not pay corporate-level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 15-percent rate available for individual shareholders.

[35] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

the character of its net long-term and, for taxable years beginning before January 1, 2008, net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution in a taxable year beginning before January 1, 2008 to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[36]

A RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[37] generally may designate a dividend it pays in a taxable year beginning before January 1, 2008 as derived from that interest income, to the extent of such income.[38] Nonresident aliens and foreign corporations are not subject to tax on such interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Chile

Chile has an integrated tax system under which it collects a total 35-percent tax on business profits. This tax is imposed at two levels. First, business profits of companies resident in Chile are subject to the First Category Tax at a rate of 20 percent. Second, in the case of nonresident shareholders, distributions are subject to Additional Tax at a rate of 35 percent of the gross amount of the distribution. Nonresident shareholders are allowed a credit for the First Category Tax in computing their liability for the Additional Tax. The effective rate of Additional Tax after a credit for the First Category Tax is 15 percent.

Proposed treaty limitations on internal law

In general

Under the proposed treaty, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the dividend-paying company is resident (the source

[36] The exception described in the immediately preceding footnote also applies for distributions by RICs.

[37] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

[38] Sec. 871(k)(1)(C).

country), but the rate of tax is limited. Under the proposed treaty, source-country taxation of dividends generally is limited to 15 percent of the gross amount of the dividends paid to residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company. The Technical Explanation provides that for application of this principal by the United States, shares are considered voting shares if they provide the power to elect, appoint or replace any person vested with the powers ordinarily exercised by the board of directors of a U.S. corporation. Additionally, the Technical Explanation states that the determination of whether the ownership threshold is met for purposes of determining the applicability of the five-percent rate is made on the date on which entitlement to the dividend is determined. Thus, the determination would generally be made on the dividend record date.

The term "beneficial owner" is not defined in the proposed treaty and therefore is defined under the internal law of the country imposing tax (*i.e.*, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

According to the Technical Explanation, however, special rules apply to companies holding shares through fiscally transparent entities, such as partnerships. In such cases, the rules of paragraph 1 of the proposed protocol apply to determine whether the dividends should be treated as derived by a resident of a treaty country. The laws of the residence country determine who derives the dividend, and the laws of the source country determine whether the person who derives the dividends is the beneficial owner of the dividends. The principles of paragraph 1 of the proposed protocol also apply to determine whether other requirements have been satisfied, such as the ownership threshold that must be met to qualify for the five-percent rate under this article.

The proposed treaty provides a zero rate of withholding tax for dividends received by a pension fund, provided that the dividends are not derived from the carrying on of a business, directly or indirectly, by the pension fund.

Definitions and special rules and limitations

The proposed treaty generally defines dividends as income from shares or other corporate participation rights that are not treated as debt, as well as other amounts that are subject to the same tax treatment by the source country as income from shares (for example, constructive dividends). The Technical Explanation notes that the term is defined broadly and flexibly, and is intended to cover all arrangements that yield a return on an equity investment in a corporation as determined under the tax law of the source country, as well as arrangements that might be developed in the future.

The proposed treaty's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment. In this case, the dividends are taxed as business profits (Article 7). The reduced rates also do not apply if the beneficial owner of the dividends performs independent services from a fixed base in the country and the dividends are attributable to the fixed base. In this case, Article 14 (Independent Personal Services) will apply.

The proposed treaty prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country unless the dividends are paid to a resident of the first country or are attributable to a permanent establishment in that country. The proposed treaty also restricts the rights of a treaty country to impose corporate level taxes, other than a branch profits tax, on undistributed profits. The Technical Explanation notes that this does not restrict a treaty country's right to tax its resident shareholders on undistributed earnings of a corporation resident in the other country. Thus, the authority of the United States to impose taxes on subpart F income, earnings deemed invested in U.S. property, and income of a passive foreign investment company that is a qualified electing fund is not restricted under the proposed treaty.

The proposed treaty allows each treaty country to impose a branch profits tax on a company resident in the other country if the company has income attributable to a permanent establishment in that country, derives income from real property in that country that is taxed on a net basis under the treaty, or realizes gains taxable in that country under the treaty. In the case of the United States, the base of the tax is limited to the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (section 884). If in the future Chile also imposes a branch profits tax, the base of its tax must be limited to an amount that is analogous to the dividend equivalent amount. The rate of branch profits tax is limited to five percent.

Additional provisions in proposed protocol

The proposed protocol reflects the unique operation of Chile's integrated tax system and the Technical Explanation states that this paragraph is intended to prevent the avoidance of the Additional Tax. The proposed protocol provides that the provisions of this article of the proposed treaty do not limit the application of the Additional Tax provided that under the domestic law of Chile the First Category Tax is fully creditable in computing the amount of Additional Tax to be paid. Accordingly, the Technical Explanation states that the proposed treaty does not require Chile to reduce the rate of Additional Tax withheld on dividends paid by companies resident in Chile and beneficially owned by residents of the United States.

The proposed protocol provides that if at any time under the domestic law of Chile, the First Category Tax ceases to be fully creditable in computing the amount of Additional Tax to be paid, the amount of Additional Tax imposed by Chile will be subject to the limitations in the proposed treaty. Additionally the proposed protocol provides that if the rate of Additional Tax imposed under the domestic law of Chile exceeds 35 percent, then the provisions of the proposed treaty will apply with respect to both the United States and Chile, but the tax imposed will not exceed 15 percent of the gross amount of dividends, regardless of whether the beneficial owner is a company that owns directly 10 percent of the company paying the dividends.

Additionally, if the rate of Additional Tax exceeds 35 percent, the countries will consult to reassess the balance of benefits of this Convention to conclude a protocol to incorporate terms limiting the right of the source country to tax dividends under Article 10 (Dividends).

The proposed protocol provides that Article 10 (Dividends) does not apply in the case of distributions or dividends paid by an enterprise when the investment is subject to a foreign investment contract under the Foreign Investment Statute (DL 600), as it may be amended from time to time without changing the general principles thereof.

The proposed protocol generally denies the five-percent rate of withholding tax to dividends paid by RICs and REITs.

The 15-percent rate of withholding (or zero rate for dividends received by a pension fund) generally is allowed for dividends paid by a RIC. The 15-percent rate of withholding (or zero rate for dividends received by a pension fund) is allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividend is an individual or pension fund holding an interest of not more than 10 percent in the REIT; (2) the dividend is paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividend is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividend holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (i.e., the value of no single interest in real property held by the REIT exceeds 10 percent of the gross value of the REIT's total interest in real property).

Relation to other articles

The Technical Explanation notes that the saving clause of paragraph 4 of the proposed protocol permits the United States to tax dividends received by its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), as if the proposed treaty had not come into effect.

The benefits of the dividends article are also subject to the provisions of Article 24 of the proposed treaty (Limitation on Benefits).

Article 11. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain "excess interest" of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC's income (generally, interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor's "excess inclusion" – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

Chile

In general, Chile imposes a 35-percent withholding tax rate on interest on loans granted abroad. A withholding tax rate of four-percent applies to interest when the loans have been granted from abroad by a foreign or international bank or financial institution, certain foreign pension funds, or insurance companies. However, a withholding tax rate of 31-percent is imposed on interest related to "excess indebtedness" which consists of a debt-to-equity ratio of exceeding three to one.

Proposed treaty limitations on internal law

The proposed treaty provides that interest arising in one treaty country ("the source country") and paid to a resident of the other treaty country ("the resident country") may be taxed by the resident country. However, the source country also may tax interest arising in its country at a rate not to exceed 10 percent.[39] For interest derived from specific types of businesses and activities, the gross amount of the interest is subject to a tax rate of four percent if the interest is beneficially owned by a resident of the resident country that is: (a) a bank, (b) an insurance company, (c) an enterprise substantially deriving its gross income from the active and regular conduct of a lending or finance business (including the business of issuing letters of credit or providing guarantees, or providing charge and credit card services) involving transactions with unrelated parties, where the enterprise is unrelated to the payor of the interest, (d) 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 (e) any other enterprise, provided that in the three taxable years preceding the taxable year in which the interest is paid, the enterprise derives more than 50 percent of its liabilities from the issuance of bonds in the financial markets or from taking deposits at interest, and more than 50 percent of the assets of the enterprise consist of debt-

[39] For a period of five years from the effective date of the proposed treaty, a rate of 15 percent shall apply in place of the 10-percent rate.

claims against persons that do not have with the resident a relationship described in subparagraph (a) or (b) of paragraph 1 of Article 9 (Associated Enterprises). However, if the interest is paid as part of an arrangement involving back-to-back loans or other arrangement that is economically equivalent and intended to have a similar effect to back-to-back loans, the source country may tax the gross amount of the interest at a rate not to exceed 10 percent.

The proposed treaty defines interest as income from debt-claims of every kind, whether or not secured by mortgage. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term interest also includes all other income that is treated as income from money lent under the tax law of the treaty country in which the income arises. Income from debt-claims that carry a right to participate in the debtor’s profits are regarded as interest under this Article if the contract clearly evidences a loan at interest. Interest does not include income covered in Article 10 (Dividends).

The preferential treaty tax rates do not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country or performs independent personal services from a fixed base situated in the source country, to the extent the interest is attributable to such permanent establishment or fixed base. In such circumstances, assuming the beneficial owner of the interest is a resident of one of the treaty countries, the interest is taxed as business profits (Article 7) or independent personal services (Article 14). According to the Technical Explanation, interest attributable to a permanent establishment or fixed base but received after the permanent establishment or fixed base is no longer in existence is taxable in the country in which the permanent establishment or fixed base existed.

The proposed treaty provides a source rule for interest whereby interest generally is considered to arise in a treaty country if paid by a resident of that country. An exception to this general rule applies when interest on a debt is incurred in connection with a permanent establishment or a fixed base in a treaty country and borne by such permanent establishment or fixed base. In such instances, the interest is deemed to arise in the country where the permanent establishment or fixed base is located.

The proposed treaty addresses non-arm’s-length interest charges between a payor and a beneficial owner that have a special relationship. Paragraph 8 of Article 11 provides that the article applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country with due regard being given to other provisions of the proposed treaty. For example, excess interest paid to a parent corporation may be treated as a dividend under a country’s internal laws and, accordingly, would be entitled to the benefits of Article 10 (Dividends). The Technical Explanation notes that the term “special relationship” is not defined in the proposed treaty and states that the United States considers the term to include the relationships described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of section 482 of the Code.

The proposed treaty provides two anti-abuse exceptions to the general source-country rules for taxation of interest. The first exception relates to contingent interest payments. If interest arising in the source country is determined with reference to (1) receipts, sales, income, profits, or other cash flow of the debtor or a related person, (2) any change in the value of any property of the debtor or a related person, or (3) any dividend, partnership distribution, or similar payment made by the debtor or a related person, the interest may be taxed in the source country in accordance with its laws. If the beneficial owner is a resident of the resident country, however, the interest may not be taxed at a rate exceeding the rate prescribed in paragraph 2(b) of Article 10 (Dividends).

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. Such interest may be taxed by each treaty country in accordance with its domestic law. The Technical Explanation states that this exception is consistent with the policy of sections 860E(e) and 860G(b) of the Code that excess inclusions with respect to a REMIC should bear full U.S. tax in all cases.

The proposed treaty permits a treaty country ("first treaty country") to impose a branch level interest tax on a company resident in the other treaty country ("second treaty country"). The tax may be imposed on the excess, if any, of the amount of interest allocable to the profits of a company (1) with a permanent establishment in the first treaty country (including gains under paragraph 3 of Article 13 (Capital Gains)), or (2) subject to tax in the first treaty country under Article 6 (Income from Real Property) or paragraph 1 of Article 13 (Capital Gains), over the interest paid by that permanent establishment, or in the case of profits subject to tax under Article 6 or paragraph 1 of Article 13, over the interest paid by that trade or business in the first treaty country is deemed to arise in such country and be beneficially owned by a resident of such country. This branch level interest tax rate may not exceed the generally applicable rates provided in Paragraph 2 of this Article.

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 4 of the proposed protocol that permits the United States to tax its residents and citizens, subject to the special foreign tax credit rules of paragraph 4 of Article 23 (Relief from Double Taxation), and are available only if a resident satisfies the limitation-on-benefits requirements of Article 24.

Article 12. Royalties

Internal taxation rules

United States

Under the same system that applies to dividends and interest, the United States imposes a 30-percent withholding tax on U.S.-source royalties paid to foreign persons. U.S.-source royalties include royalties for the use of or right to use intangible property in the United States.

Chile

In general, Chile-source royalties paid to nonresident companies and individuals are subject to a 30-percent withholding tax rate. However, several exceptions provide reduced withholding tax rates.[40] If certain criteria are met, no withholding tax rate is imposed on royalty payments related to standard software. A 15-percent withholding tax rate is imposed on royalty payments related to the use and exploitation of patents, industrial models, industrial designs and drawings, integrated circuit designs and routings, new vegetable varieties, and certain computer software programs. A 20-percent withholding tax rate also applies for royalties payments for television broadcasting and cinematographic materials.

Proposed treaty limitations on internal law

The proposed treaty provides that royalties arising in a treaty country ("the source country") and paid to a resident of the other treaty country ("the resident country") may be taxed by the resident country.

The source country also may tax the royalties in accordance with such country's domestic laws. However, if the beneficial owner of the royalties is a resident of the resident country, the tax rate shall not exceed:

1. Two percent of the gross amount of the royalties described in (a) below, and

2. Ten percent of the gross amount of the royalties described in (b) below.

For these purposes, the term "royalties" means: (a) payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial or scientific equipment, but not including ships, aircraft or containers as dealt with in Article 8 (International Transport); and (b) payments of any kind received as a consideration for the use of, or right to use, any copyright of literary, artistic, or scientific 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; the term royalties also includes gain derived from the alienation of any such property described in (b), to the extent such gain is contingent on the productivity, use, or disposition of the property. The Technical Explanation states that any gain from the alienation of royalty-producing property that is not contingent on the productivity, use, or disposition of the property is gain addressed in Article 13 (Capital Gains).

The preferential treaty tax rates do not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country, or performs independent personal services from a fixed base in the source country, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In that event, the royalties are taxed as business profits (Article 7). According to the Technical Explanation, royalties attributable to a permanent establishment or fixed base but received after the permanent establishment or fixed base is no longer in existence remain taxable under the provisions of Article 7 (Business Profits), and not under this article.

[40] Reduced withholding rates are not available for payments made to related entities or companies resident in countries (or territories) considered tax havens by the Chilean Ministry of Finance.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length amount is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and, thus, entitled to the benefits of Article 10 (Dividends).

Article 13. Capital Gains

Internal taxation rules

United States

Generally, gain realized from the sale of a capital asset by a nonresident alien individual or a foreign corporation is not subject to U.S. tax unless the gain is effectively connected with the conduct of a U.S. trade or business or, in the case of a sale by a nonresident alien individual, that individual is physically present in the United States for at least 183 days in the taxable year. A nonresident alien individual or foreign corporation generally is subject to U.S. tax on gain from the sale of a U.S. real property interest as if the gain were effectively connected with a trade or business conducted in the United States. "U.S. real property interests" include interests in certain corporations if U.S. real property comprises at least 50 percent of the assets of the corporation.

Chile

Under Chilean tax rules, capital gains from the disposition of property are generally taxable at a flat 20-percent rate. Gains on the sale of publically traded shares are generally exempt from taxation.

Proposed treaty limitations on internal law

The proposed treaty provides rules governing when a treaty country may tax gains from the alienation of property by a resident of the other treaty country. The rules generally are consistent with those included in the U.S. Model treaty.

Under the proposed treaty, gains derived by a resident of one treaty country that are attributable to the alienation of immovable property (real property) situated in the other country may be taxed in that other country. For the purposes of this article, immovable property (real property) situated in the other treaty country includes: (1) immovable property (real property) referred to in Article 6 (Income from Immovable Property (Real Property))—that is, an interest in the immovable property (real property) itself; (2) in the case of the United States, a U.S. real property interest; and (3) in the case of Chile, any equivalent interest in real property (immovable property) situated in Chile, including shares or other rights deriving more that 50 percent of their value directly or indirectly from real property (immovable property) situated in Chile. The Technical Explanation clarifies that the taxation of distributions made by a REIT or by certain RICs is governed by this Article, rather than Article 10 (Dividends), when they are attributable to gains derived from the alienation of real property.

The proposed treaty includes a provision that permits a treaty country to tax gains from the alienation of movable property (that is, property other than immovable property (real property)) that are attributable to a permanent establishment that an enterprise of the other treaty country has in the first treaty country, or that are attributable to a fixed base that is available to a resident of a treaty country in the other treaty country for the purpose of performing independent personal services. This rule permits source-country taxation of gains from the alienation of the permanent establishment (alone or with the enterprise as a whole) or of the fixed base for performing independent personal services. According to the Technical Explanation, this taxation is permitted whether or not the permanent establishment exists at the time of alienation. Consequently, income that is attributable to a permanent establishment, but that is deferred and is received after the permanent establishment no longer exists, may nevertheless be taxed in the treaty country in which the permanent establishment was located. This rule is similar to a rule in U.S. internal law.

The Technical Explanation notes 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 that rise to the level of a permanent establishment. The Technical Explanation states that under the proposed treaty, the United States may tax the partner's distributive share of income realized by the partnership on the disposition of movable property forming part of the partnership's business property in the United States.

The proposed treaty provides that gains derived by an enterprise of one treaty country from the alienation of ships or aircraft operated or used in international traffic, or of personal property related to the operation of the ships or aircraft, are taxable only in the country in which the enterprise is resident. The Technical Explanation notes that this rule applies even if the gains are attributable to a permanent establishment maintained by the enterprise in the other treaty country.

Gain from the alienation of shares or other rights or interests representing the capital of a company that is resident of the other treaty country may be taxed in that other country, but the tax is limited to 16 percent of the amount of the gain. As stated in the 2010 diplomatic notes, this provision reflects the unique operation of Chile's integrated tax system and is intended to prevent the avoidance of the Additional Tax.

The proposed protocol provides that, if under the domestic law of Chile, the First Category Tax exceeds 30 percent, this provision will not apply. In such case, the 2010 diplomatic notes provide that the provision of the proposed protocol operates to limit the right of the source country to tax capital gains, and the gains will only be subject to tax in the resident country.

The proposed protocol provides that if Chile concludes an income tax treaty with another country that contains terms that further limit the right of the source country to tax capital gains, the United States and Chile will, at the request of the United States, consult to reassess the balance of benefits of the proposed treaty with a view to concluding a protocol to incorporate the lower rates into the proposed treaty.

The proposed treaty provides that notwithstanding the special provisions above, the residence country has an exclusive right to tax gains from the alienation of certain shares of a company or other rights representing the capital of a company that is a resident of the other country. Gains derived by a pension fund from the alienation of shares or other rights representing the capital of a company that is resident in the other country may be taxed only in the residence country of the pension fund. In addition, gains derived by a mutual fund or other institutional investor from the alienation of share of a company that is resident in the other country may be taxed only in the country of residence of the mutual fund or other institutional investor, provided that the company's shares are substantially and regularly traded on a recognized stock exchange located in the other country and the alienation occurred on a recognized stock exchange in the other country. The proposed protocol provides that the terms "mutual fund" and "institutional investor" do not include an investor of a treaty country which directly or indirectly owns 10 percent or more of the shares or other rights representing the capital or the profits in a company that is a resident of the other treaty country. The residence country has the exclusive right to tax gains from the alienation of shares of a company that is a resident of the other treaty country and whose shares are substantially and regularly traded on a recognized stock exchange in the other treaty country, provided that: (1) the shares were sold either on a recognized stock exchange in the other country or in a public offer for the acquisition of shares regulated by law; and (2) such shares were previously acquired either on a recognized stock exchange in the other treaty country, in a public offer for the acquisition of shares regulated by law, in a placement of first issue shares by that company at the time of the constitution of that company or of an increase in the capital of that company, or in exchange of bonds convertible into shares.

The proposed treaty includes two exceptions to the limitations on the rate of source-country tax. As stated in the 2010 diplomatic notes, these exceptions reflect the unique operation of Chile's integrated tax system and are intended to prevent the avoidance of the Additional Tax. The source country may tax gains derived by a resident of the other treaty country if the recipient of the gain at any time during the 12-month period preceding the alienation owned shares, directly or indirectly, consisting of more than 50 percent of the capital of a company that is a resident of the other treaty country. The source country may also tax gains derived by a resident of a treaty country from the alienation of other rights that are not debt claims representing the capital of a company that is a resident of the other treaty country if the recipient of the gain at any time during the 12-month period preceding the alienation owned other such rights, directly or indirectly, consisting of 20 percent or more of the capital of that company. The proposed protocol provides that the rate of Additional Tax imposed by Chile under this provision shall not exceed 35 percent. Additionally, the proposed protocol provides that if under the domestic law of Chile the First Category Tax exceeds 30 percent, the provision above shall not apply. In such case, the 2010 diplomatic notes provide that the proposed protocol operates to limit the right of the source country to tax capital gains, and the gains will only be subject to tax in the residence country. The proposed protocol also provides that if Chile concludes an income tax treaty with another country that contains terms that further limit the right of the source country to tax capital gains, the United States and Chile will, at the request of the United States, consult to reassess the balance of benefits of the proposed treaty with a view to concluding a protocol to incorporate the lower rates into the proposed treaty.

The proposed treaty grants to the resident country the exclusive right to tax gains from the alienation of any property other than property specifically listed in this article.

The proposed treaty includes a special rule that seeks to avoid double taxation that could result for the application of expatriation taxes. This rule provides that if an individual, on ceasing to be a resident of one treaty country is treated as alienating any property for its fair market value and is taxed in that country, then the individual may make an election with respect to tax treatment in the other treaty country. Under the election, the individual is treated as having alienated and reacquired the property for an amount equal to its fair market value immediately before he ceased to be a resident of the first treaty county. However, the individual may not make the election in respect of property situated in the other treaty country. The Technical Explanation provides that an individual must make the election consistently with respect to all properties treated as alienated, and states that an individual treated as alienating multiple properties under this special rule may make the election only if the deemed alienation of all such properties results in a net gain. The Technical Explanation elaborates that at the time the treaty was signed, certain types of property are excluded from the deemed disposition rules in the case of individuals who cease to be citizens or long-term residents of the United States: a deferred compensation item as defined under Code section 877A(d)(4), a specified tax deferred account as defined under Code section 877A(e)(2), and an interest in a nongrantor trust as defined under Code section 877A(f)(3).

The Technical Explanation states that the saving clause of paragraph 4 of the proposed protocol permits the United States to tax its citizens and residents as if the proposed treaty had not come into effect. In addition, the benefits of this article are available only to a treaty country resident that satisfies one of the conditions in Article 24 (Limitation on Benefits).

Article 14. Independent Personal Services

Internal taxation rules

United States

The United States taxes the income of a nonresident alien individual at the regular graduated rates if the income is effectively connected with the conduct of a trade or business in the United States by the individual. The performance of personal services within the United States may constitute a trade or business within the United States.

Under the Code, the income of a nonresident alien individual from the performance of personal services in the United States is excluded from U.S.-source income, and therefore is not taxed by the United States in the absence of a U.S. trade or business, if the following criteria are met: (1) the individual is not present in the United States for over 90 days during the taxable year; (2) the compensation does not exceed $3,000; and (3) the services are performed as an employee of, or under a contract with, a foreign person not engaged in a trade or business in the United States, or are performed for a foreign office or place of business of a U.S. person.

Chile

A nonresident individual generally is subject to Chilean tax only on Chilean source income. A foreign individual who becomes a Chilean resident generally is subject to tax only on Chilean source income for the first three years of residence.

Proposed treaty limitations on internal law

Under the proposed treaty, income derived by an individual who is a resident of one treaty country in respect of professional services or other activities of an independent character is generally taxable only in that country. This services income may, though, be taxed in the other treaty country in two situations. If a resident of a treaty country has a fixed base regularly available in the other treaty country for purposes of performing activities of an independent character, that other treaty country may tax the individual on the income that is attributable to the fixed base and is derived from services performed in any other country than the residence country. If a resident of a treaty country is present in the other treaty country for a period or periods of 183 days or more in any 12-month period beginning or ending in the relevant taxable year (for example, the calendar year in which services are performed), that other treaty country may tax the income that is derived from the individual's activities performed in that other country. According to the Technical Explanation, this 183-day period is measured using the days of physical presence method of the Code. Under this method, a day generally is counted if part or all of the day is spent in the host country.

The Technical Explanation states that income derived by persons other than individuals or groups of individuals from the performance of independent personal services is not covered by Article 14 but instead by Article 7 (Business Profits). Employees of companies to which Article 7 applies are, in turn, taxable in accordance with Article 15 (Dependent Personal Services).

If income of a resident of a treaty country is taxable in the other treaty country as independent personal services under Article 14 (because attributable to a fixed base or because the 183-day requirement is satisfied), that other treaty country may tax the income only on a net basis under the principles of paragraph 3 of Article 7 (Business Profits). All expenses necessary for the production of the services income subject to tax in the other treaty country, including expenses not incurred in that other country, must be allowed as deductions in computing the net income subject to tax in that other country.

The term "professional services" includes, but is not limited to, independent scientific, literary, artistic, educational, and teaching activities. It also includes independent activities of physicians, lawyers, engineers, architects, dentists, and accountants. Article 14 also applies to income in respect of "other activities of an independent character," a term not defined in the proposed treaty. The Technical Explanation provides that these activities include personal services performed by an individual for his own account, whether as a sole proprietor or a partner, in situations in which the individual receives the income and bears the risk of loss arising from the services. According to the Technical Explanation, however, the taxation of an individual's income from services that are covered by Article 16, 17, or 18 is governed by one of those articles and not by Article 14. For example, a corporate director's income is taxed in accordance with Article 16.

The Technical Explanation states that the meaning of the term "fixed base" is understood to be identical to the definition of the term "permanent establishment" as defined in Article 5 (Permanent Establishment). According to the Technical Explanation, whether a fixed base is regularly available to an individual is determined based on all facts and circumstances.

The proposed treaty's inclusion of an independent personal services article departs from the U.S. Model treaty. The U.S. Model treaty has no separate article for income from independent personal services. Because the U.S. Model treaty defines a business to include the performance of professional services and other activities of an independent character, the rules of Article 7 (Business Profits) of the U.S. Model treaty govern income from independent personal services. The earlier U.S. model treaty, the U.S. Model Income Tax Convention of September 20, 1996 (the "1996 U.S. Model treaty"), included an independent personal services article, and Article 14 of the proposed treaty is largely consistent with that article. One difference between the two articles is that, unlike Article 14 of the proposed treaty, the 1996 U.S. Model treaty article permitted source-country taxation only of income attributable to a fixed based, not of income in other circumstances in which the taxpayer receiving the income satisfied a 183-day physical presence test.

This article is subject to the saving clause of paragraph 2 of Article 1 (Personal Scope). Thus, if a U.S. citizen who is resident in Chile performs independent personal services in the United States, the United States may tax the income attributable to such services without regard to the restrictions of this article, subject to the foreign tax credit described in Article 23 (Relief from Double Taxation).

Article 15. Dependent Personal Services

Under the proposed treaty, salaries, wages, and other remuneration derived in respect of employment in one treaty country (the source country) by a resident of the other treaty country are taxable in the country of residence, and generally the remuneration may also be taxed in the source country. However, the income may be taxed only by the country of residence if three requirements are met: (1) the individual is present in the source country for not more than 183 days in any 12-month period commencing or ending in the taxable year concerned; (2) the individual is paid by, or on behalf of, an employer who is not a resident of the source country; and (3) the remuneration is not borne by a permanent establishment or a fixed base of the employer in the source country. The Technical Explanation states that these rules apply to any form of compensation for employment, including payments in kind.

The proposed treaty includes a special rule that permits remuneration derived by a resident of one treaty country in respect of employment as a member of the regular complement of a ship or an aircraft operated in international traffic to be taxed only in the country of residence. According to the Technical Explanation, the "regular complement" includes the crew but also may include other individuals such as, in the case of a cruise ship, entertainers and lectures employed by the shipping company. The use of the term "regular complement" is, according to the Technical Explanation, intended to clarify that a person who exercises his employment as, for example, an insurance salesman while aboard a ship or aircraft is not covered by this Article.

This article is subject to the provisions of the separate articles of the proposed treaty covering directors' fees (Article 16), pensions, social security, alimony, and child support (Article 18), and government service (Article 19). The Technical Explanation notes that even though the source country may have the right to tax employment income under Article 15, it may not be permitted to tax the income under the proposed treaty if the income is, for example, described in Article 18 and is allowed to be taxed under that article exclusively by the residence country.

This article is substantially identical to Article 14 (Income from Employment) of the U.S. Model treaty. The proposed treaty's title for Article 15, Dependent Personal Services, is the same as the title used for the article with the equivalent rules in the 1996 U.S. Model treaty.

Article 16. Directors' Fees

Under the proposed treaty, directors' fees and other similar payments derived by a resident of one treaty country in his capacity as a member of the board of directors or an equivalent body of a company that is a resident of the other treaty country may be taxed by the treaty country where such fees or payments arise. Such fees or payments will be deemed to arise in the treaty country in which the company is resident, except to the extent that such fees or payments are paid in respect of attendance at meetings held in the other treaty country. There is no similar exception under the U.S. Model treaty, which provides that such fees and payments are taxable in the country in which the company is resident.

The rule in this article is an exception to the more general rules of Articles 7 (Business Profits), 14 (Independent Personal Services, and 15 (Dependent Personal Services). Thus, as noted in the Technical Explanation, it is not relevant to establish whether the fee is attributable to a permanent establishment in a treaty country in determining whether a director's fee paid to a nonemployee director is subject to tax in the country of residence of the corporation.

Article 17. Artistes and Sportsmen

This article addresses the taxation in a treaty country of entertainers and sportsmen resident in the other treaty country from the performance of services as entertainers and sportsmen. The Technical Explanation states that the proposed treaty applies to the income both of an entertainer or sportsman who performs services on his own behalf and of an entertainer or sportsman who performs services on behalf of another person, either as an employee of that person, or pursuant to any other arrangement. The rules of this article take precedence, in some circumstances, over those of Articles 14 (Independent Personal Services) and 15 (Dependent Personal Services)

In general

Paragraph 1 describes the circumstances in which a treaty country may tax the performance income of an entertainer or sportsman who is a resident of the other treaty country. Under the paragraph, income derived by an individual resident of a treaty country from activities as an entertainer or sportsman exercised in the other treaty country may be taxed in that other country if the amount of the gross receipts derived by the performer exceeds $5,000 (or its equivalent in Chilean pesos) for the taxable year. In contrast, under the U.S. Model treaty, the monetary threshold is $20,000. The Technical Explanation states that the determination as to whether the $5,000 threshold has been exceeded is made separately with respect to each year of payment.

According to the Technical Explanation, the monetary threshold is intended to reach entertainers and athletes who are paid relatively large sums of money for short periods of service, and who would, therefore, normally be exempt from host-country tax under the standard personal services income rules.

Tax may be imposed under paragraph 1 even if the performer would have been exempt from tax under Articles 14 or 15. On the other hand, if the performer would be exempt from host-country tax under Article 17, but would be taxable under either Articles 14 or 15, tax may be imposed under either of those articles. For example, a performer who receives less than the $5,000 threshold amount and therefore is not taxable under Article 17 may nevertheless be able subject to tax in the host country under Articles 14 or 15 if the tests for host-country taxability under the relevant article are met.

The Technical Explanation provides that Article 17 applies to all income connected with a performance by the entertainer, such as appearance fees, award or prize money, and a share of gate receipts. Income derived from a treaty country by a performer who is resident of the other treaty country from other than actual performance, such as royalties from record sales and payments for product endorsements, is not covered by Article 17, but by other articles of the treaty, such as Article 7 (Business Profits) or Article 12 (Royalties). The Technical Explanation provides that in determining whether income falls under Article 17 or another article, the controlling factor will be whether the income in question is predominantly attributable to the performance itself or to other activities or property rights.

According to the Technical Explanation, where an individual fulfills a dual role as performer and non-performer (such as a player-coach or actor-director), but his role in one of the two capacities is negligible, the predominant character of the individual's activities should control the characterization of those activities. In other cases, there should be an apportionment between the performance-related compensation and other compensation.

<u>Income accrues to another person</u>

Paragraph 2 of Article 17 is intended to address the potential for circumvention of the rule in paragraph 1 when a performer's income does not accrue directly to the performer himself, but instead accrues to another person.

The relationship may truly be one of employee and employer, with no circumvention of paragraph 1 either intended or realized. On the other hand, the "employer" may, for example, be a company established and owned by the performer, which is merely acting as the nominal income recipient in respect of the remuneration for the performance (a "star company"). The performer may act as an "employee," receive a modest salary, and arrange to receive the remainder of the income from his performance from the company in another form or at a later time. In such case, absent the provisions of paragraph 2, the income could arguably escape host-country tax because the company earns business profits but has no permanent establishment in that country. The performer may largely or entirely escape host-country tax by receiving only a small salary, perhaps small enough to place him below the dollar threshold in paragraph 1.

Paragraph 2 seeks to prevent this type of abuse. Under paragraph 2, when the income accrues to a person other than the performer, and the performer or related persons participate, directly or indirectly, in the receipts or profits of that other person, the income may be taxed in the treaty country where the performer's services are exercised, without regard to Articles 7 or 14. Taxation under paragraph 2 is imposed on the person providing the services of the performer. Paragraph 2 does not affect the rules of paragraph 1, which apply to the performer himself. According to the Technical Explanation, the income taxable by virtue of paragraph 2 is reduced to the extent of salary payments to the performer, which fall under paragraph 1.

For purposes of paragraph 2, income is deemed to accrue to another person (*i.e.*, the person providing the services of the performer) if that other person has control over, or the right to receive, gross income in respect of the services of the performer. Direct or indirect participation in the profits of a person may include, but is not limited to, the accrual or receipt of deferred remuneration, bonuses, fees, dividends, partnership income or other income, or distributions. The Technical Explanation includes an example illustrating that the payment of salaries by a company to performers is not sufficient to establish that the performers participate in the profits of the company, where the performers receive their salaries out of the company's gross receipts.

<u>Relationship to other articles</u>

This article is subject to the provisions of the saving clause of paragraph 4 of the proposed protocol. Thus, if an entertainer or a sportsman who is resident of Chile is a U.S. citizen, the United States may tax all of his income from performances in the United States without regard to the provisions of this article, subject to the foreign tax credit provisions of Article 23 (Relief from Double Taxation). In addition, benefits of this article are subject to the provisions of Article 24 (Limitation of Benefits).

<u>Article 18. Pensions, Social Security, Alimony and Child Support</u>

This article addresses the taxation of pension payments (both private and government), social security benefits, contributions to pension funds, and alimony and child support payments.

<u>Private pension payments</u>

The proposed treaty includes rules for the taxation of private pension payments and other similar remuneration derived by a resident of one treaty country from sources within the other treaty country. In general, the proposed treaty permits both countries to tax these payments, but it limits source-country taxation to 15 percent of the gross amount of a payment. This rule differs from the U.S. Model treaty provision. That provision generally allows exclusively residence country taxation of pension payments and similar remuneration.

The proposed treaty provides an exception to the residence country's right to tax cross-border pension payments and similar remuneration. Under this exception, if a resident of one treaty country receives a payment from a pension plan of the other treaty country (the source country) that is exempt from income taxation in the source country and is operated to provide pension or retirement benefits, the country of residence of the recipient of the payment may not tax the amount of the payment that would be excluded from taxable income in the source country if the recipient of the payment were a resident of the source country. To illustrate this rule, the Technical Explanation notes that Chile, for example, is permitted to tax a Chilean resident on a distribution from a U.S. Roth IRA only to the extent the distribution would be taxed by the United States if it were received by a U.S. resident.

According to the Technical Explanation, the term "pension payments and other similar remuneration" includes both periodic and lump sum payments. This remuneration, according to the Technical Explanation, is intended to include payments made by qualified private retirement plans. In the United States, these plans include qualified plans under section 401(a); 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 section 408(p) accounts); section 403(a) qualified annuity plans; and section 403(b) plans. Distributions from section 457 plans may also meet be covered by the rules described above if they are not paid with respect to government services.

Pensions in respect of government service

The proposed treaty provides that any pension paid from the public funds of a treaty country or a political subdivision or a local authority of that treaty country to an individual in respect of services rendered to that country or subdivision or authority in the discharge of functions of a governmental nature may be taxed only by that country. If, however, the individual receiving the pension is a resident and national of the other treaty country, the pension may be taxed only by that other treaty country. The Technical Explanation states that pension paid to retired civilian and military employees of either the Chilean or U.S. government are intended to be governed by these rules. These rules are similar to those for government pensions in Article 19 (Government Service) of the U.S. Model treaty.

The rules just described do not apply to social security payments. Separate rules for those payments are described next.

Social security benefits

The proposed treaty, like the U.S. Model treaty, provides for exclusive source-country taxation of payments made under provisions of the social security or similar legislation of that country. Payments made under provisions of the social security or similar legislation of a treaty country include payments made under a pension plan or fund created under the social security system of that treaty country. Paragraph 18 of the proposed protocol provides that in the case of Chile the social security system is any pension scheme or 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), and that in the case of the United States the phrase "similar legislation" is intended to refer to tier 1 Railroad Retirement benefits.

According to the Technical Explanation, the rules for the taxation of social security payments apply to all social security benefits, both for an individual who contributed to the social security system as a government employee and for an individual who contributed as a private sector employee.

Although there are two distinct rules for the taxation of social security benefits and the taxation of pensions in respect of government service, in most circumstances both rules provide the same treatment – exclusive source-country taxation. In one circumstance, however, the treatment under the two rules is different. If a national and a resident of one treaty country receives a pension payment from the other treaty country (the source country) in respect of government service, that payment generally is taxable only by that individual's country of residence, whereas a social security payment would be taxable only by the source country. If, however, the individual in question were a citizen (or, in cases in which the United States was the source country, a lawful permanent resident of the United States) of the source country, the payment would remain taxable by that country.

Pension funds

If a resident of one treaty country is a beneficiary of a pension or other retirement plan that is established in the other treaty country and is generally exempt from income taxation in that other treaty country, the proposed treaty prohibits the treaty countries from imposing tax on income earned but not distributed by the plan. The proposed treaty permits a treaty country to impose taxation only to the extent that a payment or other similar remuneration is made from the plan and is not transferred to another pension fund in the country in which the plan is organized.

To illustrate these rules, the Technical Explanation describes the tax consequences when a U.S. citizen contributes to a U.S. qualified plan while working in the United States and then establishes residence in Chile. In that situation, according to the Technical Explanation, the proposed treaty forbids the United States and Chile from taxing currently the plan's earnings and accretions with respect to the U.S. citizen. The proposed treaty allows taxation only when and to the extent that a payment or other similar remuneration is made from the plan and is not transferred to another pension fund in the United States. When a payment is made, the rules described previously (subject to possible application of the saving clause, described below) govern taxation of that payment.

The proposed treaty includes rules, in paragraph 5 of Article 18, providing benefits when a resident of one treaty country (the "home country") contributes to a pension fund in that home country and performs services for a limited time in the other country (the "host country"), whether or not the individual becomes a resident of that other country. In that circumstance, if certain requirements are satisfied, contributions that the individual makes to the home country pension fund in respect of services performed in the host country must, for a period of up to 60 months in the aggregate, be treated by the host country in the same manner for its tax purposes as a contribution made to a pension plan established in the host country. For example, according to the Technical Explanation, if a participant in a U.S. qualified plan works temporarily in Chile, Chile must treaty contributions to the U.S. qualified plan as contributions to a pension plan that is generally exempt from income taxation in Chile and is operated primarily to provide pension or retirement benefits in Chile.

The requirements that must be satisfied for benefits under this provision are the following. The individual in question must have been contributing on a regular basis to the home country pension plan, or to another similar pension plan for which the new plan was substituted, for a period ending immediately before the individual became a resident of or was present in the host country. The competent authority of the host country must agree that the pension plan in question generally corresponds to a pension plan recognized for tax purposes by that host country.

Paragraph 19 of the proposed protocol provides that the Chilean pension plan eligible for benefits under this competent authority rule include the following and any identical or substantially similar plan established under legislation introduced after the proposed protocol was signed: any pension scheme or 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).* The proposed protocol provides that the U.S. plans eligible for benefits of this competent authority rule include the following and any identical or substantially similar plan that is established by legislation introduced after the proposed protocol was signed: qualified plans under Code section 401(a) (including 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 section 408(p) simple retirement accounts), section 403(a) qualified annuity plans, section 403(b) plans, section 457(g) trusts providing benefits under section 457(b) plans, and the Thrift Savings Fund (section 7701(j)). For any of the plans described in paragraph 19 of the proposed protocol, a taxpayer need not obtain a determination from the relevant competent authority that the plan generally corresponds to a pension or retirement plan established in and recognized for tax purposes in the country of that competent authority.

The proposed treaty restricts the relief allowed by these paragraph 5 rules to the same relief that would be allowed by the host country to residents of that country for contributions to, or benefits accrued under, a pension plan established in that country. For example, the Technical Explanation states that when the United States is the host country, the amount of contributions that may be excluded for U.S. tax purposes from an employee's income under paragraph 5 is limited to the U.S. dollar amount specified in Code section 415 or the U.S. dollar amount specified in section 402(g) to the extent contributions are made from the employee's compensation.

According to the Technical Explanation, the rules of paragraph 5 do not address the treatment of employer contributions.

Alimony and child support

The proposed treaty exempts from taxation in both treaty countries periodic payments that are made by a resident of one treaty country to a resident of another treaty country under a written separation agreement or a divorce, separate maintenance, or compulsory support decree. This exemption extends to payments for the support of a child.

If, however, an individual who makes a payment to which this provision applies is entitled to a deduction or other relief from tax for the payment in his country of residence, the other treaty country may tax the payment.

Saving clause

Under paragraph 4(a) of the proposed protocol, paragraphs 1(b), 3, 4, and 6 of Article 18 are not subject to the saving clause of paragraph 4 of the proposed protocol. Consequently, the United States will not tax U.S. citizens and residents on income described in those paragraphs even if those amounts otherwise would be subject to U.S. tax under U.S. law.

Under paragraph 4(b) of the proposed protocol, paragraphs 2 and 5 of Article 18 are not subject to the saving clause with respect to individuals who are neither citizens of the treaty country conferring the benefits nor persons who have been admitted for permanent residence in that country (green card holders in the United States). To illustrate the effect of this rule, the Technical Explanation states that, notwithstanding paragraph 2 of Article 18, the United States may tax pension payments from Chilean public funds to a U.S. permanent resident or citizen who is a Chilean national and resident. Likewise, notwithstanding paragraph 5 of Article 18, a person who becomes a U.S. permanent resident or citizen will not be entitled to a deduction or exclusion for contributions to a pension plan established in Chile in a situation in which the United States is the host country under paragraph 5.

Article 19. Government Service

Under paragraph 1 of Article 19 of the proposed treaty, remuneration, other than a pension paid to an individual for services rendered to a treaty country (or political subdivision or local authority) is taxable only in that country. However, the remuneration is taxable only in the other treaty country if the services are rendered there and the individual is a resident of that other treaty country who is either a national of that other treaty country or who did not become a resident of that other country solely for purpose of rendering the services. According to the Technical Explanation, the provision applies to anyone performing services for a government, whether as an employee, an independent contractor, or an employee of an independent contractor.

Paragraph 2 of Article 19 provides that the remuneration described in paragraph 1 will be subject to the rules of Articles 15 (Dependent Personal Services), 16 (Directors' Fees), and 17 (Artistes and Sportsmen) if the services rendered by an individual are in connection with a business conducted by a government.

Under subparagraph 4(b) of the proposed protocol, the saving clause does not apply to the benefits conferred by one of the treaty countries under this article if the recipient of the benefits is neither a citizen of that state nor a person who has been admitted for permanent residence (*i.e.*, in the United States, a "green card" holder). Thus, a resident of the United States who, in the course of performing functions of a governmental nature, becomes a resident (but not a permanent resident) of Chile would be entitled to the benefits of this article.

Article 20. Students and Trainees

Under the proposed treaty, a student or business trainee who visits a treaty country ("host country") and who is, or was immediately prior to visiting the host country, a resident of the other treaty country, is exempt from income tax under certain conditions specified in the article.

First, the purpose of the visit must be for full-time education at a recognized educational institution such as a university, college or school, or the full-time training of the visitor. Whether a student is to be considered full-time will be determined by the rules of the educational institution at which he is studying. Visitors coming principally to work in the host country, but who are also part-time students, would not be entitled to the benefits of this article.

Second, the host-country exemption applies to payments that are received by the student, apprentice, or business trainee for purposes of his maintenance, education, or training, and that arise or are remitted from outside the hose country. A payment will be considered to arise outside the host country if the payer is located outside the host country. Where appropriate, substance prevails over form in determining the identity of the payer. In contrast to the U.S. Model treaty, the host-country exemption applies to payments that are received as compensation for personal services.

In the case of business trainees, the exemption from income tax in the host country applies only for a period not exceeding two year from the time the visitor first arrives in the host country for the purpose of training. In contrast, the U.S. Model treaty applies for a period not exceeding one year. The Technical Explanation states that, if a business trainee remains in the host country for more than two years, he will not retroactively lose the treaty benefits of the article for the first two years.

Article 21. Other Income

This article is a catch-all provision intended to cover items of income not specifically covered in other articles, and to assign to either the United States or Chile the right to tax income from third countries. As a general rule, items of income not otherwise dealt with in the proposed treaty which are beneficially owned by a resident of one of the treaty countries are taxable only in the country of residence.

The general rule described above is modified in two ways. First, income, other than income from immovable property, that is received by a resident of a treaty country and that is effectively connected with a permanent establishment or a fixed base maintained in the other treaty country may be taxed by that other country under the rules of Article 7 (Business Profits) and Article 14 (Independent Personal Services). This rule is consistent with the rule in the U.S. Model treaty. The Technical Explanation states that the rule applies even if the income is sourced in a third country. The carve-out of income from real property means that, consistent with the rules of Article 6 (Income from Real Property (Immovable Property)), income from real property located in the residence country or in a third country is taxable only in the residence country (and not the source country) even if the income is attributable to a permanent establishment or a fixed base in the source country.

Second, the general rule described previously is modified to allow the source country a nonexclusive right to tax other income arising within the source country. As a result, both the residence country and the source country may tax this income, leaving the resulting double taxation to be resolved under Article 23 (Relief from Double Taxation). This provision is a departure from the U.S. model but is consistent with the U.N. model and with treaties that the United States has concluded with developing countries.

The Technical Explanation offers as examples of other income gambling winnings, punitive damages, payments for a covenant not to compete, and income from certain financial instruments that does not arise in the conduct of a trade or business. The Technical Explanation also notes that the article applies to items of income that are not dealt with because of their source. For example, interest arising in a third country that is not attributable to a permanent establishment in the United States or Chile is subject to Article 21.

The Technical Explanation states that because partnership distributions generally do not give rise to income, those distributions generally are not addressed by Article 21. Similarly, according to the Technical Explanation, trust income and distributions that have the character of the associated distributable net income generally are covered by another article of the proposed treaty.

This article is subject to the saving clause. Accordingly, the United States may tax an individual who is a Chilean resident and a U.S. citizen on the individual's income that is not dealt with elsewhere in the proposed treaty. The benefits of this article are also subject to the provisions of Article 24 (Limitation on Benefits).

Article 22. Taxation of Capital

This article of the proposed treaty provides rules for each treaty country's taxation of capital of a resident of the other treaty country. Neither the United States nor Chile[41] imposes a tax on capital. However, the article would apply in the event that either country enacts a capital tax in the future.

The proposed treaty provides that, except in limited circumstances described in the next paragraph, capital of a resident of one treaty country may be taxed only by that country. In particular, under Article 22 capital represented by ships, aircraft, and containers owned by a resident of one treaty country and operated in international traffic and capital represented by personal (movable) property related to the operation of those ships, aircraft, and containers may be taxed only by the treaty country in which the person is resident.

In two situations the proposed treaty permits a treaty country to tax capital of a resident of the other treaty country. A treaty country may tax capital represented by real property (immovable property) referred to in Article 6 (real property (immovable property)) that is situated in that country and is owned by a resident of the other treaty country. Similarly, a treaty

[41] The Technical Explanation notes that, at the time of signing the proposed treaty, Chile did not impose a tax on Capital. Treasury has confirmed that Chile does not impose a tax on Capital as of the date of this pamphlet.

country may tax capital represented by personal property (movable property) forming part of the business property of a permanent establishment that an enterprise of the other treaty country has in that first treaty country, and it also is permitted to tax capital represented by personal property (movable property) related to a fixed base available in that first country to a resident of the other treaty country for the purpose of performing independent personal services.

The U.S. Model treaty does not include rules related to the taxation of capital. The OECD Model Tax Convention on Income and Capital (the "OECD Model"), by contrast, provides rules governing the taxation of capital, and this article of the proposed treaty is consistent with the OECD Model's rules.

Article 23. Relief from Double Taxation

Internal taxation rules

United States

The United States taxes the worldwide income of its citizens and residents. It attempts unilaterally to mitigate double taxation generally by allowing taxpayers to credit the foreign income taxes that they pay against U.S. tax imposed on their foreign-source income. An indirect or "deemed-paid" credit is also provided. Under this rule, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and that receives a dividend from the foreign corporation (or an inclusion of the foreign corporation's income) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid for the year the dividend is received.

A fundamental premise of the foreign tax credit is that it may not offset U.S. tax on U.S.-source income. Therefore, the foreign tax credit provisions limit the foreign taxes that a taxpayer may claim as credits for the year to the amount of the taxpayer's U.S. tax liability attributable to its foreign-source income. The limitation is computed separately for "passive category income" and other income to prevent the crediting of foreign taxes on certain high-taxed foreign-source income against the U.S. tax on certain types of traditionally low-taxed foreign-source income. Other limitations may apply in determining the amount of foreign taxes that may be credited against the U.S. tax liability of a U.S. taxpayer.

Chile

Chilean residents are subject to income tax on their worldwide income. In general, double taxation relief is provided in the form of a tax credit available for foreign taxes paid on foreign-source income. The tax credit is generally limited to the lesser of the Chilean business income tax of 20 percent, or the foreign tax effectively paid. In the case of foreign dividend income and income from profit distributions, the credit is limited to the lesser of 30 percent of net foreign source income or the foreign tax effectively paid. Effective January 1, 2014, an indirect foreign tax credit is available for foreign taxes paid by a same-country foreign subsidiary of a company distributing profits to its Chilean parent if the distributing company holds, directly or indirectly, at least a 10 percent ownership of the same-country subsidiary. Additionally, the foreign tax credit limitation for foreign dividend income and income from profit distributions is increased from 30 percent to 35 percent with respect to taxes paid from a country that has a tax treaty in force with Chile, and from 30 percent to 32 percent otherwise.

Proposed treaty

Overview

One of the principal purposes for entering into an income tax treaty is to limit double taxation of income earned by a resident of one of the countries that may be taxed by the other country. Unilateral efforts to limit double taxation are imperfect. Because of differences in rules as to when a person may be taxed on business income, a business may be taxed by two countries as if it were engaged in business in both countries. Also, a corporation or individual may be treated as a resident of more than one country and be taxed on a worldwide basis by both.

Double taxation is addressed in other articles of the proposed treaty that limit the right of a source country to tax income. This article provides further relief in circumstances in which both Chile and the United States still tax the same item of income. This article is not subject to the saving clause; the country of citizenship or residence will waive its overriding taxing jurisdiction to the extent that this article applies.

U.S. tax relief for taxes paid to Chile

Paragraph 1 of Article 23 generally provides that the United States will allow a U.S. citizen or resident a foreign tax credit for the income taxes paid or accrued to Chile, and will allow a U.S. corporation a deemed-paid credit when the U.S. corporation receives dividends from a Chilean corporation in which the U.S. corporation owns 10 percent or more of the voting stock. The credit generally is to be computed in accordance with the provisions and subject to the limitations of U.S. law (as that law may be amended from time to time without changing the general principles of the proposed treaty provisions). This provision is similar to those found in the U.S. Model treaty and many U.S. tax treaties, and is consistent with U.S. law.

The proposed treaty provides that the taxes referred to in paragraphs 3(b) and 4 of Article 2 (Taxes Covered), excluding taxes on capital.

Chilean tax relief for taxes paid to the United States

Paragraph 2 provides that Chile will provide relief from double taxation through the credit method. Chile agrees in paragraph 2, in accordance with and subject to the provisions of the law of Chile, to allow a credit against Chilean tax for income taxes payable on income from sources outside Chile.

U.S. citizens who are resident of Chile

Paragraph 3 provides special rules for the tax treatment of certain types of income derived by U.S. citizens who are residents of Chile. Since U.S. citizens, regardless of residence, are subject to U.S. tax on their worldwide income, the U.S. tax on the U.S.-source income of a U.S. citizen who is a resident of Chile may exceed the U.S. tax that may be imposed under the proposed treaty on an item of U.S.-source income derived by a resident of Chile who is not a

U.S. Citizen. The Technical Explanation states that the provisions of paragraph 3 ensure that Chile does not bear the cost of U.S. taxation of its citizens who are residents of Chile.

Subparagraph 3(a) provides a special credit rule for Chile that limits the amount of credit Chile must allow a resident of Chile. The rule applies to items of U.S.-source income that would be either exempt from U.S. tax or subject to reduced rates of U.S. tax under the provisions of the proposed treaty if they had been received by a resident of Chile who is not a U.S. citizen. The tax credit allowed by Chile under paragraph 3 with respect to such items is limited to the U.S. tax that may be imposed under the proposed treaty, other than U.S. tax imposed solely by reason of the U.S. citizenship of the taxpayer under the provisions of the saving clause of paragraph 4 of the proposed protocol.

For example, according to the Technical Explanation, if a U.S. citizen resident in Chile receives royalties described in subparagraph 3(b) of Article 12 (Royalties) from sources within the United States, the foreign tax credit granted by Chile would be limited to 10 percent of the gross amount of the royalties--the U.S. tax that may be imposed under subparagraph 2(b) of Article 12--even if the shareholder is subject to U.S. net income tax because of his U.S. citizenship.

Subparagraph 3(b) eliminates the potential for double taxation that can arise because subparagraph 3(a) provides that Chile need not provide full relief for the U.S. tax imposed on its citizens resident in Chile. Subparagraph 3(b) provides that the United States will credit the income tax paid or accrued to Chile, after the application of subparagraph 3(a). It further provides that in allowing the credit for the taxes paid to Chile, the United States will not reduce its tax below the amount that is creditable against Chilean tax under subparagraph 3(a).

Since the income described in subparagraph 3(a) will generally be U.S.-source income, special rules are required to re-source some of the income to Chile in order for a taxpayer to be able to credit the tax paid to Chile. This re-sourcing is provided for in subparagraph 3(c), which deems the items of income referred to in subparagraph 3(a) to be from foreign sources to the extent necessary to avoid double taxation under subparagraph 3(b).

The Technical Explanation includes two examples illustrating the application of paragraph 3 to a U.S. citizen resident in Chile ("the U.S. citizen") that receives a $100 U.S.-source royalty payment. In both examples, the U.S. rate of tax on residents of Chile, under subparagraph 2(b) of Article 12, is 10 percent, and the U.S. income tax rate on the U.S. citizen is 35 percent ("the U.S. citizenship tax").

In the first example, the Chilean tax rate that applies to the U.S. citizen that is resident in Chile is 25 percent (below the U.S. rate). In the example, Chile allows the U.S. citizen to take a credit of $10 ($100 multiplied by 10 percent) against the Chilean resident tax of $25 under subparagraph 3(a). As a result, the net tax the U.S. citizen pays to Chile post-credit is $15. In applying subparagraphs 3(b) and 3(c), the U.S. citizen first calculates the pre-credit citizenship tax of $35 ($100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the $10 of credit that the U.S. citizen takes against the Chilean income tax under subparagraph 3(b), the maximum U.S. citizenship tax eligible to be offset by a credit is $25 ($35 pre-credit citizenship tax less $10 of Chilean credit attributable to the royalty payment). As the $15 of net tax the U.S. citizen pays to Chile is less than the $25 of U.S. citizenship tax that may be offset by a credit, the U.S. citizen may take a credit of $10 under subparagraph 3(b). Subparagraph 3(c) then applies to re-source $42.86 ($15 divided by 35 percent) of the U.S.-source royalty payment as foreign-source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

In the second example, the Chilean tax rate that applies to the U.S. citizen that is resident in Chile is 40 percent (above the U.S. rate). In this example, Chile allows the U.S. citizen to take a credit of $10 ($100 multiplied by 10 percent) against the Chilean resident tax of $40 under subparagraph 3(a). As a result, the net tax the U.S. citizen pays to Chile post-credit will be $30. In applying subparagraphs 3(b) and (c), the U.S. citizen first calculates the pre-credit citizenship tax of $35 ($100 multiplied by 35 percent). Since the tax the U.S. citizen owes to the U.S. government may not be less than the $10 of credit that the U.S. citizen takes against the Chilean income tax under subparagraph 3(b), the maximum U.S. citizenship tax eligible to be offset by a credit is $25 ($35 pre-credit citizenship tax less $10 of Chilean credit attributable to the royalty). As the $30 of net tax the U.S. citizen pays to Chile is greater than the $25 of U.S. citizenship tax that may be offset by a credit, there is $5 of excess foreign tax credit available for carryover. Subparagraph 3(c) then applies to re-source $71.43 ($25 divided by 35 percent) of the U.S.-source royalty payment as foreign-source income in the current year so that the U.S. citizen may take the credit under the U.S. foreign tax credit limitation.

Other forms of tax relief

Paragraph 4 of Article 23 provides that where in accordance with the proposed treaty income derived or capital owned by a resident of a treaty country is exempt from tax in that treaty country, the treaty country may nevertheless take into account the exempted income or capital in calculating the amount of tax on the remaining income or capital of such person

Paragraph 5 of Article 23 provides a re-sourcing rule for gross income covered by paragraph 1. Under paragraph 5, items of gross income, as determined under the laws of a treaty country, derived by a resident of that treaty country that under the proposed treaty may be taxed in the other treaty country (other than solely by reason of paragraph 4 of the proposed protocol), shall be deemed to be income from sources in the other treaty country. The Technical Explanation indicates that paragraph 5 is intended to ensure that a resident of a treaty country can obtain an appropriate amount of foreign tax credit for income taxes paid to the other treaty country when the proposed treaty assigns to the other treaty country primary taxing rights over an item of gross income.

Relationship to other Articles

Article 23 is not subject to the saving clause of paragraph 4 of the proposed protocol. Thus, the United States will allow a credit to its citizens and residents in accordance with this article, even if the credit were to provide a benefit not available under the Code (such as the re-sourcing provided by subparagraph 3(c) and subparagraph 5).

Article 24. Limitation on Benefits

In general

Article 24 limits those benefits that are dependent upon residency of the claimant to residents who are qualified persons within the meaning of this article. Generally, the limitation operates to ensure that beneficiaries of the treaty have a sufficient nexus with a treaty country. Neither the mutual agreement procedures nor benefits to members of embassy staff, under Article 26 (Mutual Agreement Procedures) and Article 28 (Members of Diplomatic Missions and Consular Posts), respectively, are restricted by this article. The limitation-on-benefits provision includes restrictions similar to the limitations article included in the U.S. Model treaty, as well as rules developed and included in recent U.S. income tax treaties to address triangular arrangements and headquarters companies.

A resident of either treaty country, as determined under Article 4 (Residence), may satisfy the restrictions of this article in one of three ways, subject to several antiabuse provisions. First, a resident who is within one of the seven categories enumerated in paragraph 2 of Article 24 is entitled to all benefits that are accorded by the proposed treaty on the basis of residency. In addition, residents that do not meet one of the seven categories may be entitled to treaty benefits with respect to certain items of income if the income is derived from conduct of an active business. Third, the competent authority of one treaty country may grant treaty benefits to a resident of the other treaty country with respect to an item of income if he determines that treaty shopping was not a principal purpose of the transaction or structure giving rise to the income.

Finally, anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases." Together, these provisions deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents. Treaty shopping may occur when residents of third countries attempt to benefit from a treaty by organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Income stripping may result if a third-country resident eligible for favorable treatment under the tax rules of its country of residency is able to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made.

Categories of residents that qualify for all treaty benefits

The following seven types of residents are qualified residents entitled to full treaty benefits: (a) an individual other than one receiving income as a nominee for, or on behalf of, a beneficial owner resident in a third-country; (b) one of the two treaty countries, or a political subdivision or local authority thereof; (c) a public company, or its subsidiary; (d) a resident company that performs headquarter functions for a multinational group of companies and is subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country and has independent authority in carrying out its supervisory and administrative functions; (e) a pension fund, if more than 50 percent of the organization's beneficiaries, members, or participants are individuals resident in either the United States or Chile; (f) an organization that is established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, regardless of its tax exempt status under the residence country's domestic law; or (g) an entity that satisfies both an ownership test and a base erosion test. The rules to establish qualified resident status as a public company, a headquarters company or a resident who satisfies an ownership-base erosion test are defined in greater detail in the proposed treaty, as explained below.

Public companies and subsidiaries

A company that is a resident of the United States or Chile is a qualified person entitled to all treaty benefits if, in the case of a publicly-traded company, it satisfies the "regular trading test" and either the "primary trading test" or the "management and control test," or, in the case of a subsidiary of a publicly-traded company, it satisfies the "vote or value test."

1. Regular trading, plus either primary trading or management and control

Under the regular trading test, the proposed treaty permits a company to qualify based on regular trading of the principal class of its shares, and any disproportionate class of shares, on one or more recognized stock exchanges, provided that either (1) the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (the "primary trading test"), or (2) the company's primary place of management and control is in its country of residence (the "management and control test"). Certain key elements of the regular trading test and its components, the primary trading test, and management and control test, are described below.

Neither the term "regularly traded" nor "primarily traded" is defined in the proposed treaty. Undefined terms used in a treaty are generally construed consistently with the domestic laws of the relevant treaty country, usually the source country. Under U.S. law, both terms are defined in the regulations promulgated to administer the branch profits tax.[42] According to the Technical Explanation, the relevant regulation[43] provides that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during the year. The Technical Explanation notes that trading on one or more recognized stock exchanges in either treaty country may be aggregated for purposes of meeting the "regularly traded" requirement. In order to be considered to be primarily traded in the company's country of residence under the relevant regulatory definition of "primarily trading," the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident must exceed the number of shares in the

[42] Under section 884(e), a foreign corporation is exempt from the branch profits tax otherwise imposed by section 884 if it is a qualified resident of a country with which the United States has an income tax treaty. In defining "qualified resident," the Code provides a special rule for certain publicly traded corporations and their subsidiaries, permitting them to be treated as qualified residents.

[43] Treas. Reg. section 1.884-5(d)(4)(i)(B).

company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.[44]

The term "recognized stock exchange" is defined as U.S. and Chilean exchanges specified in the proposed treaty as well as any exchanges that the competent authorities agree should be recognized. The U.S. exchanges specified in the treaty are the NASDAQ System owned by the National Association of Securities Dealers, Inc. and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934. The Chilean exchanges specified are the Bolsa de Comercio, the Bolsa Electronica de Chile, the Bolsa de Corredores, and any stock exchange recognized by the Superintendencia de Valoures y Seguros under Chilean law.

The regular trading test requires that both the principal class of shares and any disproportionate class of shares be regularly traded on one of the recognized stock exchanges. These classes of shares are defined in article 24, as follows. The "principal class of shares" is the class of ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the term is used to refer collectively to those classes of shares that together represent a majority of the aggregate voting power and value of the company. A "disproportionate class of shares" is defined as any outstanding class of shares that is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, if a company resident in Chile has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States, that class of stock shall be considered a disproportionate class of shares.

If the principal class of shares of a company is regularly traded on a recognized stock exchange but does not satisfy the primary trading test, the company may qualify for treaty benefits under the management and control test if its primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test has been interpreted to mean the place where the board of directors meets. Under the proposed treaty, by

[44] Treas. Reg. section 1.884-5(d)(3)

contrast, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

2. Vote or value test

In an alternative to the regular trading test, companies may qualify for treaty benefits if at least 50 percent of the vote or value of its shares are owned directly or indirectly by five or fewer companies entitled to benefits under the regular trading test. A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test. In order for a company to meet the vote or value on the basis of indirect ownership, each intermediate owner must be a resident of the United States or Chile. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the proposed treaty.

Headquarters companies

Under the proposed treaty, a resident of the United States or Chile is entitled to treaty benefits if that person functions as a headquarters company for a multinational corporate group described below, whether or not it owns shares in the entities that it supervises. A potential headquarters company must perform substantial supervisory and administrative functions for a group of companies in its country of residence. The group of companies for which it performs services must operate and derive income from a genuinely multinational active business, as determined from its operations in at least five different countries, deriving gross income from each country above specified thresholds without earning excessive amounts from any one non-treaty country or from the other treaty country (that is, the treaty country in which it is not a resident). The headquarters company must be subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country, and must have independent authority in carrying out its supervisory and administrative functions. U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland include similar rules for headquarters companies, although the U.S. Model treaty does not. A person is considered a headquarters company for this purpose only if each of several criteria is satisfied.

1. Overall supervision and administration

To be considered a headquarters company, a person must provide a substantial portion of the overall supervision and administration of the multinational corporate group. This supervision and administration may include group financing, provided that group financing is not the principal activity of the company. The Technical Explanation states that a person will be considered to engage in supervision and administration only if it engages in a number of the following activities: group financing (but, as mentioned above, not as its principal activity), pricing, marketing, internal auditing, internal communications, and management. In determining whether a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, that company's headquarters-related activities must be substantial in relation to the same activities for the same group performed by other entities.

2. Genuinely multinational active trade or business

The multinational corporate group supervised by a headquarters company must consist of companies that are engaged in an active business in, and reside in, at least five countries (or five groupings of countries). The business activities carried on in each of those five countries or groupings must constitute at least 10 percent of the gross income of the group. This active trade or business rule, as well as the limitations on gross income earned in a single country limitation or in the other treaty country, are intended to ensure that the relevant group is truly multinational. According to the Technical Explanation, the income from multiple countries may be aggregated into nonoverlapping groupings in determining whether the 10-percent gross income requirement is satisfied. So long as there are either five or more individual countries or groupings that each satisfy the 10-percent requirement, the requirement is met. In addition, if the gross income requirement is not satisfied for a taxable year, it may be deemed to be met if the average gross income from the four preceding years exceeds the 10-percent gross income threshold.

The Technical Explanation gives the following example of the operation of the active trade or business requirement. CHQ is a Chilean resident that functions as a headquarters company for a group of companies resident in the United States, Canada, New Zealand, the United Kingdom, Malaysia, the Philippines, Singapore, and Indonesia. In 2012, the total gross income of the multinational corporate group is $137, of which $40 is generated in the United States, $25 in Canada, $10 in New Zealand, $30 in the United Kingdom, $10 in Malaysia, $7 in the Philippines, $10 in Singapore, and $5 in Indonesia. Ten percent of the group's gross income in 2012 is $13.70; only the United States, Canada, and the United Kingdom satisfy the 10-percent requirement by themselves. Together, the New Zealand and Malaysia members generate $20 of gross income, and the Philippines, Singapore, and Indonesia members together generate $22 of gross income. These two groupings therefore may be treated as the fourth and fifth members of the group (in addition to the United States, Canada, and the United Kingdom) under the active trade or business requirement, and the requirement is satisfied in 2012. The composition of the groupings may change from year to year. Thus, if in 2013, the income of the Canadian resident company did not exceed the 10-percent requirement but that of the New Zealand company did, Canada could be included in the fourth grouping in lieu of New Zealand to determine whether the threshold is met.

3. Single-country income limitation

The business activities carried on in any one country other than the residence country of the headquarters company may not equal or exceed 50 percent of the gross income of the group. If this less-than-50-percent requirement cannot be met for a taxable year, the taxpayer may apply the 50 percent test to the averages for the four immediately preceding years. The Technical Explanation provides an example of the application of this rule:

Example: CHQ is a corporation resident in Chile. CHQ functions as a headquarters company for a group of companies. CHQ derives dividend income from a U.S. subsidiary in the 2008 taxable year. The countries of residence of the companies in the group, the sites of their activities, and the amounts of gross income attributable to the companies for the years 2008 through 2012 are set forth below:

Country	**Situs**	**2012**	**2011**	**2010**	**2009**	**2008**
United States	U.S.	$100	$100	$95	$90	$85
Mexico	U.S.	10	8	5	0	0
Canada	U.S.	20	18	16	15	12
United Kingdom	U.K.	30	32	30	28	27
New Zealand	N.Z.	35	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore	30	25	24	22	20
TOTAL		$260	$257	$238	$221	$207

Because the U.S. situs companies' total gross income of $130 in 2012 is not less than 50 percent of the gross income of the group, the provision is not satisfied with respect to dividends derived in 2012. However, the U.S. situs companies' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2008 through 2011 is $111 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111 represents 48.1 percent of the group's average gross income for the years 2008 through 2011, the United States satisfies the single-country limitation.

4. Other treaty country gross income limitation

No more than 25 percent of gross income of a headquarters company that is a resident of one treaty country may be derived from the other treaty country. Thus, according to the Technical Explanation, if the headquarters company's gross income for the taxable year is $200, no more than $50 of gross income may be derived from the other treaty country. If this gross income requirement is not met for the taxable year, it may also be satisfied based on the average percentage for the four preceding years.

5. Independent discretionary authority

The headquarters company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions described above for the overall supervision and administration requirement. The Technical Explanation states that this determination is made separately for each function. Thus, if a headquarters company is nominally responsible for group financing, pricing, marketing, and internal auditing functions, and another entity is actually directing the headquarters company as to the group financing function, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it may have such authority for the other functions.

6. Income taxation rules

The headquarters company must be subject to the same income taxation rules in its country of residence as apply to persons who are entitled to treaty benefits with respect to certain items of income that satisfies the active business test. The Technical Explanation states that the requirement should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active trade or business would be subject. Thus, a headquarters company is not entitled to treaty benefits under the headquarters company rules if it is subject to special taxation legislation that imposes a lower rate of income tax on headquarters companies in a treaty country than is imposed on companies engaged in the active conduct of a trade or business, or otherwise artificially lowers the taxable base for headquarters companies in the treaty country.

7. In connection with or incidental to a trade or business

The income that a headquarters company resident in one treaty country derives in the other treaty country must be derived in connection with or be incidental to the active business activities described in the special active trade or business requirement under the headquarter company rules, above. For example, according to the Technical Explanation, if a Chilean company that satisfied the other requirements of the headquarters company rules acted as a headquarters company for a group that included a U.S. company, and the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Chilean company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business to be entitled to treaty benefits under the headquarters company rules. The Technical Explanation similarly states that interest income received from the U.S. company also would be entitled to treaty benefits as long as the interest was attributable to the computer business supervised by the headquarters company. Interest income derived from an unrelated party, however, normally would not be considered to be in connection with or incidental to the active trade or business supervised by the headquarters company.

Ownership and base erosion test

The ownership and base erosion test provides a residual category under which residents not described in the other categories of residents listed in paragraph 2 may qualify for full treaty benefits. To satisfy both prongs of the test, the resident of the treaty country must establish a requisite level of ownership by residents who do qualify for treaty benefits and that at least 50 percent of its income earned remains subject to taxation in the treaty jurisdiction.

The ownership test is met if at least 50 percent of each class of the entity's shares or other beneficial interests is owned, directly or indirectly, by residents of that treaty country who are otherwise entitled to full treaty benefits under the limitation-on-benefits article without regard to the ownership and base erosion test. The qualifying owners must be individuals, governments, public companies, pension funds, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test. In addition, the test includes a temporal requirement, in that the requisite ownership must be met on at least half the days of the taxable year of the person claiming treaty benefits under this test.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence). According to the Technical

Explanation, the beneficial interests in a trust are considered to be owned by its beneficiaries in proportion to the actuarial interest of each beneficiary. For purposes of applying the ownership test to trusts, the remainder beneficiary is considered to have an interest equal to 100 percent minus the aggregate interests determined for the income beneficiaries. An interest in a trust will not be considered to be owned by a person entitled to full treaty benefits unless the actuarial interest of the beneficiary can be determined. As a result, when an actuarial interest of any beneficiary cannot be determined, the ownership test can be satisfied only if all possible beneficiaries are persons otherwise entitled to benefits as individuals, governments, public companies, pension funds, or tax-exempt organizations.

The base erosion test requires that less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, public companies, pension funds, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for tangible property or services do not count against the entity in determining whether the base erosion threshold is reached, nor do deductions for amortization or depreciation. According to the Technical Explanation, trust distributions that are deductible from the taxable base are deductible payments for purposes of determining whether the 50 percent threshold is reached.

Certain income entitled to treaty benefits

Under the proposed treaty, residents of a treaty country that do not qualify for full treaty benefits under any of the tests described above may qualify for limited treaty benefits with respect to certain items of income derived from the other treaty country if the income is derived in connection with, complements, or is incidental to an active trade or business conducted by the resident in its country of residence. If the income derived from the other treaty country is from a related person, the proposed treaty also imposes a substantiality requirement for the business activities in the country of residence in relation to the activities in the source country. For purposes of determining whether income qualifies for the benefits, activities by persons related to the resident of a treaty country may be attributed to that resident.

Active conduct of trade or business

The business of making or managing investments for its own account does not constitute an active trade or business unless the business of the resident is banking, insurance or securities dealing.

The term "trade or business" is not defined in the proposed treaty. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed treaty, when determining whether a resident of Chile is entitled to the benefits of the proposed treaty under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states that the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business." In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the source country if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence, it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first from earnings and profits of the treaty-benefited trade or business and then from other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

Substantiality of business activity in residence country

The proposed treaty restricts the availability of the active business test by imposing a substantiality requirement if the income with respect to which treaty benefits are claimed is derived from a source related to the claimant. In such instances, the income qualifies for treaty benefits only if the trade or business activity in the residence country is substantial in relation to the trade or business activity conducted by the related entity in the source country. By limiting the substantiality requirement to transactions between related parties, the provision thwarts treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in minor business activities in its jurisdiction of residence that are of little economic cost or effect for the company as a whole, without hindering activity that is not potentially abusive.

Whether the substantiality requirement is met is determined separately for each item of income derived from the source country on the basis of all the facts and circumstances. Facts and circumstances relevant to the determination of substantiality include the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. Thus, it is possible that income from one line of business may qualify for favorable treatment under the proposed treaty, but income from another activity in the source country is ineligible.

Attribution rules

The proposed treaty provides attribution rules to be used in determining whether a person is engaged in the active conduct of a trade or business in a treaty country and whether it is subject to the substantiality requirement. Activities conducted by persons connected to the person claiming treaty benefits will be deemed to be conducted by that person. A person is "connected" to another person if one person possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company). Alternatively, a connection between entities exists if the entities are under common ownership, that is, one owner holds the requisite 50 percent interest in each of the entities. Regardless of the formalities of ownership, person may be considered to be connected to one another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Anti-abuse rules: The triangular structure

The proposed treaty provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Chilean resident's use of so-called "triangular structures" to avoid tax in both the source and residence countries. The Technical Explanation provides an example. A Chilean resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Chilean resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Chilean resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Chile and the third country, Chile does not tax the income earned by the permanent establishment. Alternatively, Chile may choose to exempt the income of the permanent establishment from Chilean income tax. Consequently, the income is not taxed in Chile or the United States, and is only lightly taxed in the third country.

Under the proposed treaty, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Chile and the third country is less than 60 percent of the general rate of company tax applicable in Chile.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source country, notwithstanding any other provision of the proposed treaty.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country (other than the business of making, managing, or holding investments for the person's own account, unless the business is insurance or securities activities carried on by an insurance company or registered securities dealer, or, in the case of a resident of the United States, are banking activities carried on by a bank, or in the case of a resident of Chile, are regulated services carried on by a financial institution.

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Grant of treaty benefits by the competent authority

Under the proposed treaty, a resident of a treaty country that is not otherwise entitled to treaty benefits under this article may nonetheless be granted treaty benefits if the competent authority of the other treaty country determines that the establishment, acquisition, or maintenance of the resident and the conduct of its operations did not have as one of its principal purposes the obtaining of benefits under the proposed treaty.

According to the Technical Explanation, the competent authority's discretion under this provision is broad. The competent authority, for example, may grant all treaty benefits, may grant benefits only with respect to a particular item of income, and may set time limits on the duration of any relief granted. The competent authority of the source country is required to consult with the competent authority of the residence country before denying treaty benefits under this provision.

Article 25. Non-Discrimination

The proposed treaty includes a comprehensive nondiscrimination article. The article is substantially similar to the nondiscrimination article in the U.S. Model treaty and to provisions that have been included in other recent U.S. income tax treaties. The description below explains the scope and operation of the individual paragraphs and identifies instances in which the article varies from the U.S. Model treaty.

In general, neither treaty country is permitted to discriminate against persons from the other country. Not all instances of differential treatment are discriminatory. Rather, only those differences in tax treatment that materially disadvantage a citizen or resident of one treaty country relative to a citizen or resident of the other treaty country are discriminatory within the meaning of the Article. The underlying premise of the operative paragraphs is that differential treatment that is directly related to tax-relevant differences in circumstances between two persons is not discriminatory. Examples of tax-relevant disparities in circumstances include the fact that one person is subject to worldwide taxation in a treaty country and another person is not, or the fact that an item of income may be taxed at a later date in one person's hands but not in another person's hands.

In paragraph 1, the proposed treaty provides that a national of one treaty country cannot be subject to taxation by the other treaty country if that taxation is "other or more burdensome than" that imposed on the country's own comparably situated nationals in the same circumstances. In so providing, the language is consistent with the OECD Model treaty. In contrast, the language in the U.S. Model treaty omits reference to "other" taxation. The paragraph also departs from the U.S. Model treaty in that it does not include a statement to the effect that U.S. nationals subject to tax on a worldwide basis are not in the same circumstances as Chilean nationals who are not U.S. residents. It appears to achieve the same result by providing that a person who is a citizen or national, but not a resident, of one treaty country is not in the same circumstances with respect to taxation by that treaty country as a citizen or national of the other treaty country who is also not resident in the first treaty country.

This paragraph, unlike the succeeding paragraphs in this article, refers to nationals rather than residents, this paragraph may apply to a national without regard to the limitations of Article 22 (Limitation on Benefits). The term "national" is not defined in Article 3 (General Definitions). Although the treaty generally requires resident status to claim the benefits of the treaty, under Article 1 (General Scope), this paragraph specifies that the nondiscrimination article applies to persons without respect to residence in one of the treaty countries. For example, a U.S. citizen who is resident in a third country is entitled to the same treatment in Chile as a comparably situated Chilean national.

Under paragraph 2 of the proposed treaty adheres closely to the language of paragraphs 2 and 3 of the U.S. Model Treaty. Neither treaty country may tax a permanent establishment of an enterprise of the other treaty country less favorably than it taxes income from similar activities carried on by its own enterprises. However, foreign ownership or control may justify differences in information reporting requirements, collection methods and related penalties. As under both the U.S. and OECD Model treaties, paragraph 2 makes clear that a treaty country is not obligated to grant residents of the other treaty country any personal allowances, reliefs, or reductions for tax purposes on account of civil status or family responsibilities that it grants to its own residents.

Paragraph 3 is substantially similar to that of the U.S. Model treaty, which generally prohibits discrimination in the treatment of amounts paid by an enterprise of one treaty country to a resident of the other treaty country, for purposes of computing its taxable profits, except to the extent that the anti-avoidance rules in other articles of the proposed treaty require otherwise. Those rules are prescribed in paragraph 1 of Article 9 (Associated Enterprises), paragraph 5 of Article 11 (Interest), or paragraph 4 of Article 12 (Royalties) and concern transactions between related persons. For example, the exception relating to paragraph 5 of Article 11 (Interest) would include the denial or deferral of certain interest deductions under section 163(j) of the Code, thus allowing the United States to apply its earnings stripping rules.

Debts of an enterprise of one treaty country to a resident of the other treaty country are also deductible for purposes of determining the taxable capital of the enterprise under the same conditions as if they had been owed to a resident of the first treaty country. Because the nondiscrimination provisions are not limited in application to those taxes identified in Article 2 (Taxes Covered), this provision is relevant to both treaty countries.

Paragraph 4 provides that the nondiscrimination rules also apply to companies residing in one treaty country if they are owned in whole or in part by one or more residents of the other treaty country. A company, the capital of which is wholly or partly owned or controlled, directly or indirectly, by one or more residents of the other treaty country, may not be subjected in the first country to any taxation (or any connected requirement) that is more burdensome than the taxation (or connected requirements) that the first country imposes or may impose on other similar enterprises. As noted above, some differences in treatment may be justified on the basis of tax-relevant differences in circumstances between two enterprises. In this regard, examples of Code provisions that may be understood by the treaty countries not to violate the nondiscrimination provision of the proposed treaty may include the rules that tax U.S. corporations making certain distributions to foreign shareholders in what would otherwise be nonrecognition transactions, the rules that impose a withholding tax on non-U.S. partners of a partnership, the rules that prevent foreign persons from owning stock in subchapter S corporations, and the rules that prevent foreign corporations from joining in filing consolidated returns with domestic corporations.

The proposed treaty at paragraph 5 provides that nothing in this article may be construed as preventing either of the treaty countries from imposing a branch profits tax as described in paragraph 8 of Article 10 (Dividends).

Paragraph 6 provides that the protection of this article applies to taxes of every kind and description imposed by either treaty country, or any political subdivision or local authority of that treaty country, whether or not within the definition of taxes covered in Article 2 (Taxes Covered). Unlike the U.S. Model treaty, the protection of this article does not apply to taxes in force on the date of signature of the treaty if they are not within the scope of covered taxes. For example, unemployment taxes imposed by the United States are not within the scope of the taxes covered by the treaty, but were in effect at the time the treaty was signed, and are therefore not subject to this paragraph. However, a new excise tax other than one identified in Article 1 as a covered tax, may be covered by this provision if it is enacted after the date the treaty was signed.

Paragraph 4 of the proposed protocol includes a savings clause providing that a treaty country may tax its residents or citizens as if the treaty had not come into effect, but further provides that the terms of that savings clause are specifically inapplicable to the benefits conferred by Article 25.

Article 26. Mutual Agreement Procedure

The mutual agreement provision permits the competent authorities of the treaty countries to communicate to resolve disputes and clarify issues with respect to interpretation and application of the treaty. Under this article, a person who considers that the actions of one or both of the treaty countries cause that person to be subject to tax in a manner not in accordance with the provisions of the proposed treaty may, irrespective of internal law remedies, present a case to the competent authority of the treaty country of which the person is a resident, or if the case comes under paragraph 1 of Article 25 (Non-Discrimination), to the treaty country of which the person is a national. Like the OECD Model treaty, the article imposes a time limit for doing so. By exchange of the 2010 diplomatic notes, the treaty countries have agreed to develop bilateral processes consistent with best practices identified in OECD publications, in order to facilitate implementation of this article.

Typical cases brought under the mutual agreement procedure involve economic double taxation arising from transfer pricing adjustments, but other types of cases may also be brought. For example, a taxpayer who has received income that the source country has determined is deferred compensation and therefore is taxable in that country may believe that the income is pension income and taxable only in the taxpayer's country of residence. The benefits of this article are not limited by the savings clause understood to apply to this treaty under paragraph 4 of the proposed protocol. Consequently, the United States may apply rules and definitions agreed to by the competent authorities under the mutual agreement procedure to a U.S. citizen or resident even if those rules and definitions differ from comparable provisions of the Code. In addition, the Technical Explanation states that a person may seek relief under this provision even if not entitled to benefits under Article 24 (Limitation on Benefits).

The proposed treaty provides that if an objection presented to a competent authority appears to be justified and that competent authority is not itself able to arrive at a satisfactory solution, that competent authority must endeavor to resolve the case by mutual agreement with the competent authority of the other treaty country, with a view to the avoidance of taxation that is not in accordance with the proposed treaty.

The case must be presented by the taxpayer within three years from the first notification of action that results in taxation not in accordance with the treaty. Taxpayers need not exhaust the remedies under the laws of the relevant treaty country before presenting a case to the competent authorities. The competent authorities may accept a timely submitted case even if the treaty was terminated after the tax year that is the subject of the request, and even though the ability to achieve a solution is limited by the constraints on the competent authorities by reason of the termination of the treaty.

The proposed treaty provides that any agreement reached will be implemented notwithstanding any time limits or other procedural limitations in the domestic law of either treaty country (for example, a country's applicable statute of limitations). However, consistent with the general scope of the treaty, a mutual agreement may not override benefits or allowances authorized under domestic law or by the terms of an agreement to which the treaty country is a party. As a result, according to the Technical Explanation, if a case is presented to the U.S. competent authority after the taxpayer has entered into a written settlement or closing agreement with the United States, efforts of the U.S. competent authority will be limited to seeking a correlative adjustment from Chilean authorities.

The competent authorities of the treaty countries agree to endeavor to resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the proposed treaty. The article does not specify the types of issues that may be addressed or the specific remedies that may be agreed upon, as the U.S. Model treaty does. However, it is likely that the competent authorities may, for example, negotiate with respect to allocation of income, deductions, credits, or allowances between an enterprise in one treaty country and its permanent establishment in the other treaty country, or between related persons, consistent with the arm's-length principle underlying Article 7 (Business Profits) and Article 9 (Associated Enterprises) of the proposed treaty. Authority to settle conflicts regarding the characterization of particular items of income, the characterization of persons, the application of source rules with respect to particular items of income, the meaning of a term, or the timing of an item of income is also consistent with the objective of the mutual agreement procedure. In its Technical Explanation, Treasury states that the process may be used to resolve transfer pricing issues, including entering into advanced pricing agreements. According to the Technical Explanation, mutual agreements may also be reached as to penalties, fines and interest imposed by one of the treaty countries, in a manner consistent with the proposed treaty.

The competent authorities are permitted to communicate with each other directly for purposes of reaching an agreement in the sense of this article, thus avoiding the need for the competent authorities to communicate through diplomatic channels. In addition, with the benefit of a network of bilateral treaties, multijurisdictional issues may also be resolved by the treaty countries, according to the Technical Explanation, provided that no member of the multilateral solution exceeds the scope of its authority under the respective bilateral agreements.

Article 27. Exchange of Information and Administrative Assistance

The proposed treaty provides rules governing exchange of information and administrative assistance that are substantially similar to those in the U.S. Model treaty. The description below explains the scope and operation of the individual paragraphs, as modified by Article 20 of the proposed protocol and the 2012 diplomatic notes.[45] It also identifies instances in which the article varies from the U.S. Model treaty.

The United States and Chile agree to exchange such information as is relevant in carrying out the provisions of the proposed treaty or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The use of the word "relevant" indicates the breadth of the scope of the exchanges, in establishing the

[45] Diplomatic Note no. 49, signed by the United States on February 21, 2012.

standard for determining whether or not information may be exchanged under the proposed treaty. It conforms to the standard used in Code section 7602, which is the principal source of authority for U.S. information gathering and examination of records. Under section 7602, the IRS may request to examine any books, records or other material that "may be relevant," as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell.*[46]

In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under Code section 7651 in the same manner as if the possession or territory were a state. Thus, even though paragraph 1(a) of Article 3 (General Definitions) of the proposed treaty provides a definition of "United States" that limits its meaning to its geographic sense for most purposes under the proposed treaty and specifically carves out its possessions and territories, information in the U.S. possessions or territories is subject to exchange of information pursuant to a proper request under the proposed treaty.

Information may be exchanged to enable each treaty country to administer its own domestic law, to the extent that taxation under that law is not contrary to the proposed treaty. The competent authority of one treaty country may request information about a transaction from the competent authority of the other treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed treaty. As an example, similar to the rules applicable under the OECD Model treaty, if a U.S. company and a Chilean company transact with one another through a company resident in a third country that has no treaty with the United States or Chile, the U.S. and Chilean competent authorities may, to enforce their internal rules, exchange information about prices their respective resident companies paid in their transactions with the third-country company.

The proposed treaty provides that exchange of information may include information relating to the assessment or collection of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, the taxes covered by the proposed treaty. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered). Accordingly, information about persons who are residents of neither Chile nor the United States may be requested and provided under this article. For example, if a third-country resident has a Chilean bank account and the IRS believes that funds in the account should have been, but have not been, reported, the U.S. competent authority may request information from Chile about the bank account. Similarly, the competent authorities may exchange information relating to a broader category of taxes beyond those otherwise covered by the proposed treaty, including, for example, U.S. estate and gift taxes, U.S. excise taxes, and Chilean value-added taxes.

[46] 379 U.S. 48 (1964).

Any information exchanged under the proposed treaty is to be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. The exchanged information may be disclosed only to persons or authorities (including courts, administrative bodies, and legislative bodies) involved in the administration, enforcement or oversight of the tax laws. Such functions include assessment, collection, civil and criminal prosecution, and the determination of appeals in relation to the taxes to which the proposed treaty applies. The authority to disclose information to persons involved in oversight of taxes includes authority to disclose to persons or authorities such as the tax-writing committees of the U.S. Congress and the Government Accountability Office. Such persons or authorities receiving the information may use the information only in the performance of their role in overseeing the administration of U.S. tax laws. Finally, exchanged information may be disclosed in public court proceedings or in judicial decisions.

If information is requested by a treaty country in accordance with this article, the proposed treaty provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the requested treaty country and were being imposed by that treaty country. The request for exchange of information is to be honored notwithstanding that the requested treaty country may not need the information at that time for purposes of administering its own tax rules. According to the overview of the treaty provided by the Department of State, the provision is intended to permit access to information from a bank or a fiduciary.

A treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country, to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. If a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. The statute of limitations of the treaty country making the request should govern. Even if these restrictions on information exchange were construed to relieve a treaty country of an obligation to supply information in response to a request from the other treaty country, the limitations do not preclude exchange. The requested country may choose to supply the information if doing so does not violate its internal law.

The proposed treaty also includes a paragraph which requires a treaty country to use its information gathering powers to obtain requested information, even if it would have no need for such information in a domestic tax investigation. This provision makes clear that the restrictions discussed above do not permit rejection of a request based solely on its lack of relevance under domestic law of the requested country. To the extent that local law would permit or even require rejection of a request on that basis, local law is overridden by the treaty.

The proposed treaty limits the ability of either country to posit that domestic secrecy laws preclude response to a request for information. The proposed treaty explicitly limits the scope of the general principle described above that the treaty is not intended to require any actions by a treaty country at variance with its domestic law, by providing that a treaty country cannot refuse to respond to a request for information based on the fact that the information is in the possession of financial institutions, nominees, or persons acting in an agency or fiduciary capacity. With regard to persons acting in an agency or fiduciary capacity, the scope of any override of domestic law is not clear. Thus, a competent authority receiving a request for information from a financial institution may not decline the request based on an argument that domestic bank secrecy or similar rules override the proposed treaty obligations and preclude honoring the request.

The proposed treaty also provides that the competent authorities shall not refuse to exchange information because it relates to information concerning ownership interests in a "person." This requirement is expected to have the effect of requiring disclosure of the beneficial owner of bearer shares. However, because the language in the proposed treaty refers to "interests in a person," but not to interests in "instruments" it may not be sufficiently broad to require such exchanges with respect to bearer bonds.

The proposed treaty makes it possible for a treaty country to request that responsive information be provided in an authenticated form that will facilitate use of that information in the administrative or judicial proceedings in the requesting treaty country. Upon specific request by the competent authority of a treaty country, the other treaty country competent authority must provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested treaty country with respect to its own taxes.

The exchange of information provision in the proposed treaty is generally effective for any taxable period, notwithstanding other language in Article 29 (Entry into Force). However, the 2012 diplomatic notes reflect the understanding that the availability of information about bank transactions is limited by the date of the date of the bank transaction. Prior to changes in Chilean domestic law, Chilean authorities did not have access to certain bank information, and would be unable to comply with the obligation to exchange information. By agreeing that information held by financial institutions and subject to Chilean domestic banking statutes[47] may be exchanged only if the bank transaction reflected in the information occurred on or after January 1, 2010, the effective date of the exchange of information obligation conforms to the effective date of the Chilean domestic laws that permits taxing authorities to have access to such information.

Article 28. Members of Diplomatic Missions and Consular Posts

The proposed treaty contains the rule, consistent with the U.S. Model treaty and other recent treaties, that its provisions do not affect the fiscal privileges of members of diplomatic missions or consular posts under the general rules of international law or under the provisions of special agreements. The Technical Explanation states that the agreements include any bilateral agreements, such as consular conventions, that affect the taxation of diplomats and consular officials and any multilateral agreements dealing with these issues, such as the Vienna Convention on Diplomatic Relations and the Vienna Convention on Consular Relations. The

[47] Transactions subject to Article 1 of DLF No. 707 and Article 154 of DFL No. 3.

United States generally adheres to the latter because its terms are consistent with customary international law.

The Technical Explanation also states that this article does not independently provide any benefits to diplomatic agents and consular officers. In the event that there is a conflict between the proposed treaty and international law or other treaties, under which the diplomatic agent or consular official is entitled to greater benefits under the latter, the latter laws or agreements shall have precedence. Conversely, if the proposed treaty provides a greater benefit than another agreement, the affected person could claim the benefit of the tax treaty. The savings clause of paragraph 4 of the proposed protocol does not apply to override any benefits of this article available to an individual who neither is a U.S. citizen nor has been admitted for permanent residence in the United States.

Article 29. Entry into Force

The proposed treaty provides that the treaty is subject to ratification in accordance with the applicable procedures in the United States and Chile. The treaty countries shall notify each other in writing, through diplomatic channels, when their respective applicable procedures have been satisfied. The proposed treaty will enter into force on the date of the later of the notifications. The Technical Explanation states that the relevant date is the date on the second notification documents, and not the date on which the second notification is provided to the other treaty country.

With respect to withholding taxes (principally dividends, interest, and royalties), the proposed treaty has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed treaty enters into force. The Technical Explanation provides an example, in which, as a result of the instruments of ratification being exchanged on April 25 of a given year, the treaty rate of withholding under paragraph 2 of Article 10 (Dividends) is applicable to dividends paid after June 1 of that year.

For other taxes, the proposed treaty has effect for taxable periods beginning on or after January 1 of the calendar year immediately following the date on which the proposed treaty enters into force.

The provisions of Article 27 (Exchange of Information) have effect from the date of entry into force of the proposed treaty, without regard to the taxable period which the matter relates. The proposed protocol, as amended by the 2012 diplomatic notes, provides that, notwithstanding this provision, certain bank account transaction information, discussed further in the discussion of Article 27 (Exchange of Information), will only be available with respect to bank account transactions that take place on or after January 1, 2010.

Article 30. Termination

This article provides that the proposed treaty is to remain in effect indefinitely, unless terminated by one of the treaty countries. The treaty may be terminated by either treaty country by giving to the other treaty country a notice of termination in writing through diplomatic channels on or before the 30th day of June in any calendar year beginning after the year the proposed treaty enters into force.

If notice of termination is given, the provisions of the treaty with respect to withholding at source will cease to have effect on January 1 of the next calendar year. Similarly, for other taxes, the treaty will cease to have effect for taxable periods beginning on or after January 1 of the calendar year immediately following the date on which the notice is given. For example, if notice of termination is given on May 1, 2015, then provisions of the treaty with respect to withholding at source will cease to have effect on January 1, 2016. For calendar year companies, the treaty will cease to have effect for taxes chargeable to the tax period commencing January 1, 2016. However, for a company with a November 30 fiscal year end, the treaty will cease to have effect for taxes chargeable to the tax period commencing December 1, 2016. With respect to other provisions, the treaty will cease to have effect on January 1 of the calendar year immediately following the date on which the notice is given.

The Technical Explanation notes that nothing in this article should be construed to prevent the treaty countries from concluding a new bilateral agreement, subject to ratification, that supersedes, amends or terminates provisions of the proposed treaty without the six-month notification period. Additionally, customary international law observed by the United States and other countries, as reflected in the Vienna Convention on Treaties, allows termination by one treaty country at any time in the event of a "material breach" of the agreement by the other treaty country.

Proposed Protocol Paragraph 21. Pooled Funds

Paragraph 21 of the proposed protocol provides that, with respect to pooled investment accounts or funds that are subject to a remittance tax and are required to be administered by a resident of Chile, the provisions of the proposed treaty shall not be interpreted to restrict imposition by Chile of the tax on remittances (currently at 10 percent) from such accounts or funds in respect of the investment in assets situated in Chile.

Proposed Protocol Paragraph 22. Five-Year Review

Under paragraph 22 of proposed protocol, the United States and Chile shall consult regarding the terms, operation, and application of the proposed treaty to ensure that it continues to serve the purposes of avoiding double taxation and preventing fiscal evasion and shall, where they consider it appropriate, conclude protocols to amend the proposed treaty. Either treaty country may at any time request that consultations be conducted in an expeditious manner on matters relating to the terms, operation, and application of the proposed treaty for which urgent resolution is deemed necessary. The United States and Chile shall in any event consult to assess the terms, operation, and application of the proposed treaty within five years of the date of entry-into-force of the proposed treaty.

If Chile concludes an income tax treaty with another state that imposes a limit on rates of withholding on payments of interest and royalties lower than the limits imposed under paragraph 2 of Article 11 (Interest) and paragraph 2 of Article 12 (Royalties) or that contain terms that further limit the right of the source country to tax capital gains under Article 13 (Capital Gains), the United States and Chile shall, at the request of the United States, consult to reassess the balance of benefits of the proposed treaty with a view to concluding a protocol to incorporate such lower rates or limiting terms into the proposed treaty.

VI. ISSUES

The proposed treaty includes two issues, potential treaty shopping and the exchange of information, about which the Committee may wish to inquire. Both have been the subject of comment in the past, and neither presents concerns that are unique to the United States relationship with Chile. To some extent, these concerns may be ameliorated by the mechanism in paragraph 22 of the proposed protocol, requiring a consultation between the United States and Chile within five years of the entry into force of the proposed treaty to review the effectiveness of the treaty. The Committee may wish to inquire whether that mandatory review will encompass the effectiveness of the exchange of information program and the enforcement of the limitations on benefits and what standards for determining effectiveness will be used.

A. Treaty Shopping

In general

The proposed treaty, like nearly all U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed treaty generally is intended to benefit residents of Chile and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This practice is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides a lower rate of withholding tax on interest. The third-country investor may attempt to accomplish this result by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives – a reduction in withholding tax that would not have been possible had the investor made the loan directly from his or her country of residence.

Although the limitation on benefits rules in the proposed treaty are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical, and the Committee may wish to inquire about certain differences. In particular, the Committee may wish to examine the rules addressing publicly-traded companies, headquarters companies, and certain triangular arrangements.

Publicly-traded companies

A publicly traded company that is a resident of a treaty country is eligible for all the benefits of the proposed treaty if it satisfies the regular trading test, which requires that the company's principal class of shares (and any disproportionate class of shares) is primarily traded on one or more recognized stock exchanges, and also satisfies either the primary trading test, which requires that the company's principal class of shares be primarily traded on one or more recognized stock exchanges in its country of residence), or the management and control test, which requires that the company's primary place of management and control be in the treaty country of which the company is a resident. In addition, a subsidiary of a company may qualify for benefits as a publicly traded company by satisfying a "vote or value" test under which it establishes that at least 50 percent of vote or value is owned directly or indirectly by five or fewer companies entitled to benefits under the requirements described immediately above (that is, the regular trading test and either the primary trading test or the management and control test). A recognized stock exchange includes certain exchanges specified in the treaty, as well as any other stock exchange agreed upon by the competent authorities of the treaty countries. Trading on exchanges in either treaty country may be considered in determining whether the stock is regularly traded. In determining whether it is primarily traded in its country of residence, the proportion of trades that occur on exchanges within its country of residence must exceed trades in any other single country.

The Committee may wish to explore the rationale underlying the identification of recognized stock exchanges for purposes of limitations of benefits, and the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange. A possible rationale for the U.S. Model treaty's primary trading test is that a publicly-traded company should be eligible for treaty benefits only if it has a nexus with its country of residence, and may underlie the decision in both the proposed treaty and the U.S. Model treaty to permit substitution of the management and control test in lieu of a primary trading test. Accordingly, the Committee may wish to ask the Treasury Department to explain the latitude that available to the Competent Authorities in identifying other exchanges that may be considered in satisfying the primary trading tests. For example, the Committee may ask about circumstances under which it is appropriate to consider trading that occurs within the economic areas of the treaty countries (for example, in the case of the United States, in a country that is party to the North American Free Trade Agreement).

Headquarters companies

The proposed treaty includes special rules intended to allow treaty country benefits for a resident of a treaty country that functions as a headquarters company and that satisfies certain requirements intended to ensure that the headquarters company performs substantial supervisory and administrative functions for a group of companies: (1) that the group of companies is genuinely multinational; (2) that the headquarters company is subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country; and (3) that the headquarters company has independent authority in carrying out its supervisory and administrative functions. U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland include similar rules for headquarters companies. The U.S. Model treaty, however, does not include headquarters company rules.

The Committee may wish to ask the Treasury Department about the policies that justify deviating from the U.S. Model treaty and including rules in a treaty that grant headquarters companies treaty benefits when those headquarters companies would not be eligible for treaty benefits under any other limitation-on-benefits provision.

Triangular arrangements

The proposed treaty includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Chilean resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Chile. Although the U.S. Model treaty, however, does not include rules addressing triangular arrangements, similar anti-abuse rules are included in other recent treaties and protocols. The Committee may wish to confirm that inclusion of such rules is indicative of a shift in Treasury Department policy rather than a concern specific to the jurisdiction with which the treaty is negotiated. The Committee may also wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.

B. Exchange of Information and Administrative Assistance

Background

Tax treaties establish the scope of information that can be exchanged between treaty parties. Exchange of information provisions first appeared in the late 1930s,[48] and are now included in all double tax conventions to which the United States is a party. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in recent years, in part due to events involving UBS AG, the global financial crisis, and the general increase in globalization. In the proposed treaty, Article 26 (Exchange of Information and Administrative Assistance) closely tracks the language of the exchange of information provisions in the U.S. Model treaty in most respects. The proposed treaty facilitates the exchange of information, and tends to limit the circumstances in which the treaty countries can refuse to provide requested information. In particular, the proposed treaty permits the competent authorities to exchange such information as is relevant to the assessment, collection and enforcement of the domestic laws of the two countries, rather than limiting the information to that which is necessary. This conforms to the standard of section 7602 of the Code. The proposed treaty also requires that the other treaty country use its domestic powers to obtain the requested information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the other treaty country and were being imposed by that treaty country, whether or not the treaty country receiving the request needs the information currently. Further, the proposed treaty provides that a treaty country may not refuse to provide requested information on the basis of domestic bank secrecy laws.

The proposed treaty, in paragraph 3 of Article 25 (Mutual Agreement Procedure), permits the competent authorities to resolve doubts of interpretation or application of the convention. Although not specified, such areas for consultation and agreement may include methods for ensuring adequate reciprocity and establishing timetables and minimum thresholds of tax in controversy to warrant use of this procedure.

Chilean law relevant to exchange of information

According to the OECD, Chile is fully committed to the transparency standards of the OECD[49] and has taken numerous measures to ensure it complies with those standards. First, it has expanded its network of treaties. Chile is a signatory on 23 tax treaties that include exchange of information provisions in compliance with the OECD standards. Nineteen of those treaties have entered into force. Until 1998, the only tax treaty to which Chile was a party was with its regional trade partner, Argentina, which was executed in 1978 and entered into force in 1985. More importantly, it has made legislative changes necessary to facilitate implementation of information exchange provisions in its treaties, although the OECD identified a number of elements of transparency and exchange of information standards with respect to which Chile

[48] Article XV of the U.S.-Sweden Double Tax Convention, signed on March 23, 1939.

[49] Information in this paragraph is based on OECD, Global Forum on Transparency and Exchange of Information for Tax Purposes: Peer Reviews: Chile 2012, April 5, 2012.

needs improvement. These include the availability of ownership information of foreign companies with a nexus to Chile, the power to obtain and provide banking information, and the lack of appropriate exceptions to notification procedures which may operate to undermine effective exchange.

Until 2010, Chilean domestic law imposed significant restrictions on the ability of Chilean tax authorities to gain access to any bank information for the purpose of exchanging such information. Legislation enacted in 2009 now permits access to bank information, but only with respect to bank activity occurring on or after January 1, 2010. Thus, Chile is not considered by the OECD to be fully able to implement exchange of information consistent with the OECD standards because the tax authorities are not permitted access to information with respect to transactions prior to the effective date of the legislation, regardless of the taxable period with respect to which the information is sought. Otherwise, information gathering and enforcement powers to compel production of the information responsive to a request for exchange are adequate.

Effectiveness of the U.S. Model treaty Article 26

In addition to the above issues, which are specific to the agreement between the United States and Chile, there are several questions about the effectiveness and scope of provisions that conform to the U.S. Model treaty. Since the proposed treaty was signed, there has been extensive bilateral and multilateral cooperation in addressing issues of cross-border tax compliance and financial regulatory reform. A broad international consensus has coalesced around the issue of bank transparency for tax purposes and strengthened in the past year. Greater attention to all means of restoring integrity and stability to financial institutions has led to greater efforts to reconcile the conflicts between jurisdictions, particularly between jurisdictions with strict bank secrecy and those seeking information to enforce their own tax laws.[50] As a result, the Committee may wish to inquire as to whether the U.S. Model treaty published in 2006 remains the appropriate standard by which to measure an effective exchange of information program.

The U.S. Model treaty conforms with the norms for transparency and effective exchange of information articulated by the OECD, which are in turn the standards by which the OECD determines whether a country is committed to transparency. Those standards require the existence of mechanisms for exchange of information upon request; the availability of exchange of information for purposes of both criminal and civil tax matters; absence of restrictions of information exchange caused by application of the dual criminality principle[51] or a domestic tax

[50] See, Joint Committee on Taxation, *Description of Revenue Provisions Contained in the President's Fiscal Year 2010 Budget Proposal; Part Three: Provisions Related to the Taxation of Cross-Border Income and Investment* (JCS-4-09), September 2009. Section VI of that pamphlet provides an overview of the international efforts to address these issues.

[51] The principle of dual criminality derives from the law regarding extradition and grounds for refusal to grant a request. Extradition is generally permitted only if the crime for which a person is to be extradited is treated as a similarly serious offense in the state in which the fugitive has sought refuge. *Restatement (Third) of the Foreign Relations Law of the United States*, sec. 476 (1987). The principle is relevant to a request for exchange of tax information only if the treaty in question limits the scope of its permitted exchanges to criminal tax matters.

interest requirement; respect for safeguards and limitations; strict confidentiality rules for information exchanged; and availability of reliable information (in particular bank, ownership, identity, and accounting information) and powers to obtain and provide such information in response to a specific request.[52]

1. Methods of exchange of information

The OECD standards do not require exchange other than upon specific requests for information, although the language permits the treaty countries to agree to provide for other exchange mechanisms. The OECD, in its commentary to the exchange of information provisions in the OECD Model treaty, specifies that the treaty "allows" the competent authorities to exchange information in any of three ways that treaty countries have traditionally operated[53] – routine, spontaneous,[54] or specific exchanges.[55] With regard to the latter type of exchange, the Committee may wish to inquire as to the extent to which a request that a treaty country provide information in response to a John Doe summons[56] is a specific request within the meaning of the article, and whether protracted litigation similar to that which occurred in the UBS litigation[57] can be avoided or shortened.

The Committee may wish to explore issues related to "routine exchange of information." In this type of exchange, also referred to as "automatic exchange of information," the treaty

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[52] OECD, *Tax Cooperation: Towards a Level Playing Field, 2008 Assessment by the Global Forum on Taxation*, p. 8.

[53] OECD, Commentary on the Model Treaty Article 26, par. 9 as revised in OECD, *Update to Article 26 of the OECD Model Tax Convention and Its Commentary*, (July 12, 2012), available at http://www.oecd.org/ctp/exchange-of-tax-information/120718_Article%2026-ENG_no%20cover%20%282%29.pdf .

[54] A "spontaneous exchange of information" occurs when one treaty country who is in possession of an item of information that it determines may interest the other treaty country for purposes of its tax administration spontaneously transmits the information to its treaty country through their respective competent authorities.

[55] A "specific exchange" is a formal request by one contracting state for information that is relevant to an ongoing investigation of a particular tax matter. These cases are generally taxpayer specific. Those familiar with the case prepare a request that explains the background of the tax case and the need for the information and submit it to the Competent Authority in their country. If he determines that it is an appropriate use of the treaty authority, he forwards it to his counterpart.

[56] When the existence of a possibly noncompliant taxpayer is known but not his identity, as in the case of holders of offshore bank accounts or investors in particular abusive transactions, the IRS is able to issue a summons to learn the identity of the taxpayer, but must first meet greater statutory requirements, to guard against fishing expeditions. Prior to issuance of the summons intended to learn the identity of unnamed "John Does," the United States must seek judicial review in an *ex parte* proceeding. In its application and supporting documents,[56] the United States must establish that the information sought pertains to an ascertainable group of persons, that there is a reasonable basis to believe that taxes have been avoided, and that the information is not otherwise available.

[57] See, *United States v. UBS AG*, Civil No. 09-20423 (S.D. Fla.), enforcing a "John Doe summons" which requested the identities of U.S. persons believed to have accounts at UBS in Switzerland. On August 19, 2009, the United States and UBS announced an agreement (approved by the Swiss Parliament on June 17, 2010) under which UBS provided the requested information.

countries identify categories of information that are consistently relevant to the tax administration of the receiving treaty country and agree to share such information on an ongoing basis, without the need for a specific request. Information that is automatically shared under this authority may include information that is not taxpayer-specific, such as news about changes in domestic tax legislation, or it may comprise voluminous taxpayer filings, such as magnetic disks containing the information from IRS Form 1042-S, relating to U.S.-source fixed or determinable income paid to persons claiming to be residents of the treaty country receiving the forms. The type of information, when it will be provided, and how frequently it will be provided are determined by the respective Competent Authorities after consultation. Once an agreement is reached, the information is automatically provided.

The Committee may wish to inquire about the (1) the extent to which the United States presently engages in automatic exchange of taxpayer-specific information, (2) practical hurdles to greater use of automatic exchange, and (3) whether it anticipates significant changes in that practice should the proposed protocol be ratified. With respect to these areas of inquiry, the Committee may wish to explore the relationship between regulatory reporting requirements and automatic exchange of information, as described in the preamble to regulations finalized in 2012.

The Committee may also wish to inquire about regulations finalized in 2012 that expand information reporting by U.S. financial institutions on interest paid to nonresident aliens. In support of those regulations, the Preamble states "requiring routine reporting to the IRS of all U.S. bank deposit interest paid to any nonresidential alien individual will further strengthen the United States exchange of information program consistent with adequate provisions for reciprocity, usability and confidentiality in respect of this information."[58] Such reporting was not previously required, except with respect to payments to residents of Canada.[59] The regulations requires reporting with respect to payments to any nonresident alien who resides in a country with which the United States has a satisfactory exchange of information program under a bilateral agreement.[60] The IRS has published a list of the countries whose residents are subject to the reporting requirements, and a list of countries with respect to which the reported information will be automatically exchanged. The first list includes 78 countries. The second list includes only one, Canada.[61]

In the past, there have been concerns that information received pursuant to automatic exchanges under bilateral and multilateral agreements was not in a usable form. Examples of practical hurdles that reportedly limited the value of information exchanged were the lack of timeliness of its production, lack of conformity in reporting periods, the need to translate the language of the documents and the currencies, and its voluminous nature.[62] To the extent that

[58] Preamble to Treas. Reg. sec. 1.6049-4(b)(5). T.D. 9584, April 12, 2012.

[59] Treas. Reg. sec. 1.6049-4(b)(5).

[60] *Ibid*.

[61] Rev. Proc. 2012-24 2012 I.R.B. Lexis 242 (April 17, 2012).

[62] Letter from Commissioner, IRS, to Chairman, Senate Committee on Finance (June 12, 2006), 2006 *Tax Notes Today* 115-17.

useful information can be gathered through exchange of information, the United States may be able to reduce its reliance upon self-reporting, that is, information provided by the taxpayer and, therefore, only available with respect to those in compliance with the tax laws.

Practical challenges with automatic exchanges are not exclusive to the United States. The OECD has developed standards for the electronic format of such exchanges, to enhance their utility to tax administration.[63] Despite these efforts to standardize the information exchanged and improve its usefulness, there remain numerous shortcomings, both practical and legal, in the routine exchange of information. Chief among them is the lack of taxpayer identification numbers ("TINs") in the information provided under the exchange, despite the recommendation of the OECD that member States provide such information.[64] Ideally, the information received by the IRS should either include a TIN or be subject to a process referred to as "TIN perfection" to enable the IRS to correlate account data in the information received with a valid TIN in its taxpayer databases, although such an undertaking may be time-consuming and costly. In the course of developing standards, Working Party 10 in the OECD surveyed countries about their experience, impediments to greater use of automatic exchanges, and preferences for improving such exchanges. The Committee may wish to inquire how the United States responded to the OECD inquiries, and the priority it places on such improvements.

2. U.S. reciprocity in providing information

The United States has come under increasing pressure to eliminate policies that provide foreign persons with the ability to shelter income. The criticism has focused on disparities between the U.S. standards and foreign standards governing "know-your-customer" rules for financial institutions and the maintenance of information on beneficial ownership. With respect to the latter, U.S. norms have been criticized in recent years.[65] The Committee may wish to explore the extent to which either the existing U.S. know-your-customer rules or the corporate formation and ownership standards prevent the United States from providing information about beneficial ownership on a reciprocal basis with its treaty countries. The Committee may also consider whether there are steps to take that would help refute the perception that the United States permits states to operate as tax havens and that would help the United States better respond to information requests from treaty countries who suspect that their own citizens and

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[63] See OECD, Committee on Fiscal Affairs, *Manual on the Implementation of Exchange of Information Provisions for Tax Purposes,* Module 3 (January 23, 2006) ("OECD Exchange Manual").

[64] OECD Exchange Manual refers to a recommendation dating to 1997, "Recommendation on the use of Tax Identification Numbers in an International Context" C(97)29/FINAL (1997).

[65] Financial Action Task Force, IMF, *Summary of the Third Mutual Evaluation Report on Anti-Money Laundering and Combating the Financing of Terrorism United States of America,* pp. 10-11 (June 23, 2006); Government Accountability Office, *Company Formations: Minimal Ownership Information Is Collected and Available,* a report to the Permanent Subcommittee on Investigations, Committee on Homeland Security and Governmental Affairs, U.S. Senate GAO-06-376 (April 2006); Government Accountability Office, *Suspicious Banking Activities: Possible Money Laundering by US Corporations Formed for Russian Entities,* GAO-01-120 (October 31, 2006).

residents may be engaging in illegal activities through U.S. corporations and limited liability companies.[66]

3. Override of domestic law privileges or confidentiality

The scope and operation of the provision that overrides potential arguments based on bank secrecy law of the requested treaty country presents questions about its possible impact on other privileges. Under the proposed article in the proposed treaty and in the U.S. Model treaty, a treaty country is generally not obligated to take any action at variance with its domestic law, including disclosure of professional or trade secrets. That principle is limited by a special rule, which provides that a treaty country may not decline to provide information on the ground that the information is held by a financial institution, nominee, or person acting in an agency or intermediary capacity. The Technical Explanations to the proposed treaty and to the U.S. Model treaty state that this rule is intended to override claims of bank secrecy, but are silent about the potential intersection with the law of professional privileges.

In contrast, the OECD, in explaining a similar rule in the OECD Model, points to information that would violate safeguards against self-incrimination as an example of the type of information that a requested treaty country could decline to obtain.[67] The OECD further explains the abrogation of the general principle against requiring a country to ignore a provision of domestic law and clarifies that the provision may limit the use of certain claims of professional privilege, but only to the extent that the domestic law in question is so broad as to base its protection solely on the status of the person holding the information.[68] Under the OECD approach, a treaty country may refuse to supply information held by a bank, financial institution, agent, fiduciary or nominee as long as the ground for refusal is not the mere fact of the custodian's status as a bank, financial institution, agent, fiduciary or nominee. The OECD provides an example of a legal representative acting for a client in an agency capacity. To the extent that confidential communications between the legal representative and his client are protected under local law, the general rule against requiring a treaty country to violate its own law continues to apply and the treaty country may decline the request to exchange information.

At least one recently concluded treaty, the Income Tax Treaty between the United States and Finland,[69] departs from the U.S. Model treaty and expressly provides that the override of domestic law is not intended to include the ability to obtain information that would reveal confidential communications between a client and an attorney, in cases in which the client seeks legal advice. The Committee may wish to inquire as to the intended scope of the provision of the proposed treaty and of the U.S. Model treaty, and the extent to which the provision may override

[66] E.g., the "Incorporation Transparency and Law Enforcement Assistance Act," S. 569, 111th Congress (2009), would require States to obtain and periodically update beneficial ownership information from persons who seek to form a corporation or limited liability company.

[67] OECD, "Commentary to the OECD Model Treaty Article 26," par. 15.2.

[68] OECD, "Commentary to the OECD Model Treaty Article 26," pars. 19.12, 19.14.

[69] Senate Treaty Doc. 109-18.

any privilege or confidentiality law that may be available under a treaty country's domestic law, and the circumstances in which this provision is likely to be involved. The Committee may wish to specifically inquire about its effect on the attorney-client privilege in the United States.