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UPDATE ON THE INCOME TAX TREATY BETWEEN THE US AND CHILE

The US has income tax treaties (“ITT”) with over fifty foreign countries. Currently, three more of ITTs with additional countries, including Chile (the “US-Chile ITT”), await approval before the US Senate.

The purpose of ITTs is to reduce (or sometimes eliminate) tax rates for income earned in the other contracting country, with the goal of avoiding double taxation of the same income item.

Despite the fact that the US-Chile ITT was signed in 2010, finalizing and having it enter into force has been a slow-moving process. On June 1, 2023, the US Senate’s Foreign Relations Committee approved the US-Chile ITT. The US Senate (with votes of two thirds of the senators present at the moment of voting) must now approve it so that the treaty’s internal ratification procedure in the US can advance (Chile approved it in 2015).

If approved by the US Senate, the US-Chile ITT will become effective after both countries exchange diplomatic notes concerning the treaty. As a general rule, the US-Chile ITT will apply from January 1 of the year following its approval (e.g., January 1, 2024, if approved in 2023), with the exception of the reduced withholding rates which will become effective on the first day of the subsequent month of the ITT’s approval (e.g., September 1 if approved in July).

Below is a brief overview of some of the most relevant consequences that the US-Chile ITT would have should it be ratified.

REDUCED WITHHOLDING RATES

Generally speaking, amounts remitted from the US to Chile are subject to a 30% withholding rate. On the other hand, amounts remitted from Chile to the US are subject to a withholding rate of up to 35%.

However, if the US-Chile ITT is approved, these rates will be reduced considerably. Below are some examples of the reduced rates that would apply should the US-Chile ITT become effective:

❖ *Business Profits*

Cross-border transactions will be exempt from withholding rates.

Insurance and reinsurance premiums will be subject to a withholding rate of 5% and 2% respectively. This is of particular interest in the case of life insurance contracted with US insurance companies, which are currently subject to a 22% withholding rate.

❖ *Dividends*

Dividends paid by a US entity to a Chilean tax resident are currently subject to a 30% withholding rate. However, under the US-Chile ITT said withholding rate will be reduced to 5% (or 15%, if the person receiving the dividend owns less than 10% of the stock of the entity paying the dividend). The 5% reduced rate also applies to the Branch Profits Tax, which imposes a 30% tax on a foreign corporation’s US branch earnings that are effectively connected with a US business, provided that they are not reinvested in branch assets.

It should be noted that the Chilean withholding rate on dividends payable by a Chilean entity to a US tax resident will not be affected by the US-Chile ITT, given that Chile includes in all its ITTs a provision under which it can apply its standard 35% withholding rate on dividends (the so-called “Chile clause”).

❖ *Interest*

Without the US-Chile ITT, interest payments remitted from the US to Chile are subject to a 30% withholding rate (unless the portfolio interest exemption applies, which exempts the 30% withholding in case of interest paid to a non-resident not owning more than 10% of the US payer stock). In the case of interest payments remitted from Chile to the US, the withholding rate is 35%. The US-Chile ITT would initially reduce said rate to 15%, with a further reduction to 10% within 5 years of the treaty’s approval (subject to certain recharacterization rules).

❖ *Royalties*

As of today, royalty payments are subject to a 30% withholding rate both in the US and Chile. The US-Chile ITT would reduce this rate to 10%, and to 2% in case of royalties for the use of industrial, commercial, or scientific equipment.

❖ *Capital Gains*

In the case of the US, the general rule is that non-residents (for tax purposes) are not subject to taxes on profits earned from the sale or disposition of shares of a US entity. The US-Chile ITT is therefore silent in that regard. Separately, the US-Chile ITT does not include an exemption or withholding rate reduction with respect to taxes owed under the Foreign Investment in Real Property Tax Act (applicable in the event of sale or disposition of real property interests).

In the case of Chile, capital gains by a non-resident (for tax purposes) are subject to a 35% withholding rate. The US-Chile ITT would reduce this rate to 16% in some cases.

OTHER RELEVANT MATTERS

❖ *Double Taxation*

If approved, the US-Chile ITT will allow, with respect to the type of income included in the treaty and for which taxes have been paid in one of the member states, to be creditable against taxes paid in the other member state.

❖ *Limitation on Benefits (LOB)*

The benefits granted by the US-Chile ITT will only apply to taxpayers considered “qualified persons” under the LOB clause. The requirements vary depending on the nature of the person or entity being analyzed, but typically require substantive presence in the relevant country in order to benefit from the treaty.

❖ *Exchange of Information*

If effective, the US-Chile ITT will establish relevant obligations and exchange-of-information procedures. This is especially important considering that the US is not a member of the OECD’s Common Reporting Standard and has limited-scope agreements with Chile on this subject.

❖ Taxation of US Citizens and Double Residency Conflicts

The US includes a clause in all of its ITTs that allows it to tax its citizens and permanent residents regardless of the ITT's provisions (the so-called "Savings Clause"). However, US citizens and permanent residents that are also tax residents in Chile may apply the tie-breaker rules of the US-Chile ITT and claim the treaty's protection in order to avoid being subject to double taxation. This has important immigration and tax implications that should be carefully analyzed based on the circumstances of each individual case.

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