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The U.S. and Chile Tax Treaty and its Impact on Foreign Direct Investment

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THE U.S. AND CHILE TAX TREATY AND ITS IMPACT ON FOREIGN DIRECT INVESTMENT

by

*Hugo Hurtado**

ABSTRACT

The tax treaty signed between Chile and the United States will reduce withholding rates applicable to interest, royalties, and capital gains and will exempt certain income derived from pension funds, services, and business profits not attributable to permanent establishments. This Article concludes that the exemption and reduction of withholding taxes may have a positive impact on Chilean foreign direct investment (“FDI”) in the United States since Chilean investors and pension funds will benefit from this exemption or reduction and from the fact that a broader type of investment income (interest, capital gains, and services) will be available for tax credits under the Chilean Income Tax Law. However, it is not altogether clear whether the loss of revenues from the reduction of taxes applied to income accrued by U.S. residents in Chile will be rewarded with greater FDI from the United States in Chile. This conclusion is mainly based on the fact that unless the U.S. investor has an excess tax credit position, such reduction will be offset by the higher U.S. corporate income tax on the income. Furthermore, the loss of revenues can be especially relevant for Chile as a result of applying the most favored nation clause included in several tax treaties signed with other Organisation for Economic Co-operation and Development (“OECD”) members.

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I. INTRODUCTION

Foreign direct investment (“FDI”) from both the United States in Chile and from Chile in the United States has consistently grown in both amount and diversity during the last decade.¹ In fact, the United States is the most important source of FDI in Chile, and the United States is the second greatest recipient of Chilean FDI after Brazil.²

FDI is usually encouraged because it is considered to have a positive effect on the gross domestic product (“GDP”) of the recipient country³ based on the general argument that greater investment generates a higher GDP.⁴

A country’s GDP has three main components: consumption, investment, and government spending.⁵ The result of the interaction between the three components and its direct effect on the GDP is not altogether clear; however, at least some macroeconomists believe that a greater investment rate generates a higher GDP.⁶

Borensztein, De Gregorio, and Lee proposed that FDI has a positive effect on the GDP of the recipient country if that country has qualified human capital.⁷ The basic premise behind this positive effect is that if one of the components of GDP (investment materialized by foreign investors) increases, GDP will rise as a natural effect of this growth. However, there is

1. U.S. investment in Chile for 2009 was USD\$ 2,252 billion, whereas Chilean investment in the United States amounted to USD\$ 1,333 billion in the same period. See Amcham Chile, *Cifras Comerciales entre Chile y Estados Unidos* [Commercial figures between Chile and the United States], EL MERCURIO (Chile), Mar. 21, 2011 at SE 4, <http://www.amchamchile.cl/sites/default/files/AMCHAM%20el%20mercurio.pdf>.

2. Francisco Gaete & Miguel Ángel Urbina, *Chilean Direct Investment 2006-2009*, STUD. IN ECON. STAT. NO. 84, Mar. 2011, at 12, <http://www.bcentral.cl/estudios/estudios-economicos-estadisticos/pdf/see84.pdf> (last visited Mar. 24, 2012).

3. See Eduardo Borensztein et al., *How Does Foreign Direct Investment Affect Economic Growth?*, 45 J. INT’L ECON. 115, 115 (1998).

4. See generally Felipe Larraín, *Inversión Productiva* [Productive Investment], EL MERCURIO (Chile), Sept. 17, 2009, at B13, <http://www.mer.cl/modulos/generacion/mobileASP/detailNew.asp?idNoticia=C17858220090917&strNamePage=MERSTCE013BB1709.htm&codCuerpo=710&codRev=&iNumPag=13&strFecha=2009-09-17&iPage=1&tipoPantalla=> (analyzing the relationship between FDI and GDP using World Bank data).

5. OLIVIER BLANCHARD, *MACROECONOMICS* 46–47 (Pearson Prentice Hall, 4th ed. 2006).

6. See generally Felipe Larraín, *supra* note 4, at B13.

7. Borensztein et al., *supra* note 3, at 115.

not unanimous agreement on the subject mainly because of the considerable number of variables involved that are hard to isolate.⁸

In consequence, some countries are tempted to lower their taxes unilaterally or bilaterally — through tax treaties — in order to attract FDI with the hope of raising GDP and increasing revenue collected through income taxes.

On the other hand, FDI exposes the investor to different economic and legal systems since the tax system of the resident country together with the tax system of the country that receives the investment must be analyzed in conjunction to determine the investor's final profit.⁹

Many countries try to grant relief from uncoordinated tax systems that often create double taxation for residents conducting business abroad through the use of unilateral relief. However, since the first implementation of unilateral tax relief by the United States in 1918, most countries have understood that tools granted by domestic laws are not sufficient to deal with the different rules related to sources of income, allocation of expenses, exchange of information, dispute resolution, and other issues that arise in international trade.¹⁰ Since these goals cannot be fully achieved by unilateral measures, countries negotiate tax treaties with other countries to pursue these objectives.¹¹

The main purposes of tax treaties include avoiding double taxation and preventing tax avoidance and evasion.¹² With that in mind, the governments of Chile and the United States signed the United States of America and Chile Tax Convention (“the Treaty”) in January 2010. The Treaty is based on the 2006 U.S. Model (also including clauses from the

8. See Anil Kumar, *Does Foreign Direct Investment Help Emerging Economies*, FED. RESERVE BANK OF DALLAS ECON. LETTER (Jan. 2007) <http://www.dallasfed.org/assets/documents/research/ecllett/2007/el0701.pdf> But see Henrik Hansen & John Rand, *On the Causal Links Between FDI and Growth in Developing Countries*, 29 WORLD ECON. 21 (Jan. 2006) (pointing out that countries must reach a certain level of development in education or infrastructure before they are able to attract FDI; hence, FDI seems to have a limited effect on the GDP of less developed countries).

9. Tsilly Dagan, *National Interests in the International Tax Game*, 18 VA. TAX REV. 363, 366 (1998-1999).

10. Organisation for Economic Co-operation and Development, Comm. on Fiscal Affairs, Model Tax Convention on Income and on Capital (2005) [hereinafter 2005 OECD Model]. For an historic background on unilateral tax relief, see also Michael J. Graetz and Michael M. O’Hear, *The Original Intent of U.S. International Taxation*, 46 DUKE L.J. 1021 (1997).

11. *Id.*

12. STAFF OF J. COMM. ON TAXATION, BACKGROUND AND ISSUES RELATING TO THE TAXATION OF FOREIGN INVESTMENTS IN THE UNITED STATES (Comm. Print 1990).

2001 U.N. Model and the 2008 OECD Model Tax Convention)¹³ and is the second treaty that the United States has ever signed with a South American country.¹⁴

This Article will explore the main consequences on FDI of the Treaty between the United States and Chile and will be divided into four sections. For this purpose, the Article will analyze the major tax provisions applicable to investment income in Chile and the United States that are currently in force (without a treaty), reviewing the main changes to the domestic tax treatment of FDI provided by the Treaty. The Article will then examine the effect of the limitation of benefits clause and the tax credit system on FDI and will present conclusions, arguing that when the Treaty is in force, the Treaty's reduction of withholding rates might have an effect on Chilean investments in the United States given Chile's low corporate tax rate,¹⁵ but the rate reduction granted by the Chilean government will have an uncertain impact on United States FDI in Chile since the U.S. has a worldwide system that will offset these decreased tax rates. However, the Treaty is expected to reduce Chile's fiscal revenues because of the reduction in withholding rates and the consequential reduction in tax rates in other treaties under the most favored nation clause included in other tax treaties signed with other OECD members such as Spain, Canada, Korea, Denmark, France, Ireland, Mexico, United Kingdom, New Zealand, Sweden, and Switzerland.

13. The OECD Model Tax Convention is the main framework to negotiate tax treaties among developed countries and is based on a reciprocal level of investment flows among residents of both countries. However, the U.N. Model Tax Convention is used when a developing country negotiates a tax treaty with either a developing country or a developed country and is based on different levels of investment among countries. The main difference between both models is that the U.N. Model grants greater tax authority to the source country, thus reducing the impact on the fiscal losses derived from the signature of a tax treaty.

14. The other tax treaty signed was between the United States and Venezuela. *See* Convention Between the Government of the United States of America and the Government of Venezuela for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital, U.S.-Venez., Jan. 25, 1999, T.I.A.S. 13020, <http://www.irs.gov/pub/irs-trty/venezu.pdf>.

15. In accordance with Law No. 20.455 — enacted partially to finance Chile's reconstruction efforts after the 2010 earthquake — First Category Tax is currently set at 20 percent for 2011; 18.5 percent for 2012 and 17 percent for 2013 and beyond. Law No. 20.455, July 31, 2010, DIARIO OFICIAL [D.O.] (Chile).

II. TAXATION OF BUSINESS AND INVESTMENT INCOME IN CHILE AND THE UNITED STATES

This section will review introductory aspects of the United States and Chilean tax systems regarding investment income such as business profits, dividends, interest, royalties, and capital gains. In order to provide a practical approach to the matter, this section will analyze the current taxation of a corporation incorporated in the United States that obtains these types of profits in Chile and *vice versa* to compare it with the taxation after the Treaty is in force in the next section.

1. Taxation of Business Profits

Business profits obtained by a U.S. Corporation (“USCo”) in Chile that are considered Chilean source are generally taxable with the Additional Tax (“*Impuesto Adicional*”) at a flat rate of 35 percent under sections 58 and 60 of Decree Law number 824 of 1974 (“Chilean Income Tax Law” or “CITL”).

Income will be considered Chilean source if it arises from assets that are located in the country or from activities performed therein.¹⁶ If USCo acts directly in the country, the Additional Tax must be withheld by the resident payor of the income.¹⁷

If USCo has any kind of permanent establishment (“PE”), such as branches, offices, agents, or representatives, in Chile, a 35 percent Additional Tax will be assessed on the permanent establishment on a net basis on any income distributed to the United States¹⁸

The concept of PE is not defined in the CITL, but the Chilean Internal Revenue Service (“SII”) recognizes that this concept must be broadly interpreted.¹⁹ It basically includes any extension of USCo’s activity in Chile, through an office or a fixed place that is entitled to represent USCo and perform formal activities such as entering into agreements as per USCo’s instructions.²⁰ Therefore, a small threshold of activity is sufficient to consider that USCo is acting through a PE in Chile.²¹

16. LEY SOBRE IMPUESTO A LA RENTA [hereinafter “L.I.R.”], Law No. 824, Dec. 28, 1974, DIARIO OFICIAL [D.O.] (Chile).

17. L.I.R. art. 74.

18. SERVICIO DE IMPUESTOS INTERNOS [S.I.I.], Oficio No. 1259, Apr. 29, 2005 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2005/otras/ja935.htm>.

19. S.I.I., Oficio No. 2205, June 5, 2000 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2000/renta/junio13.htm>.

20. *Id.*

21. S.I.I., Oficio No. 2530, July 13, 1994 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/1994/renta/jul2.htm>.

The taxation of profits obtained by USco in Chile combines corporate and withholding taxes. First, once the profit is accrued, a 20 percent corporate tax called First Category Tax (“*Impuesto de Primera Categoría*”) is assessed on the business’s annual taxable income determined on an accrual basis.²² If USco acts in Chile through a subsidiary, the Additional Tax is levied only when business profits are distributed to USco. In consequence, if the subsidiary does not remit profits to the parent, the Additional Tax can be deferred.

The total effective rate payable on profits remitted abroad to a non-resident partner or shareholder, as the case may be, is normally 35 percent because the 20 percent corporate tax is generally credited against the amount due at the second level of taxation.²³

On the other hand, in order to determine the taxation of business profits of a Chilean corporation (“Chileco”) obtained in the United States, two key elements must be analyzed: whether Chileco is engaged in a U.S. trade or business and whether its income is effectively connected to a U.S. source trade or business.²⁴

Under section 882 of the Internal Revenue Code (“IRC”), if Chileco is engaged in a U.S. trade or business, it is taxable on its net effectively connected income at normal corporate rates (generally 35 percent);²⁵ otherwise, such income will be taxable at a flat 30 percent on a gross basis.²⁶

The determination of whether Chileco is engaged in a U.S. trade or business is done on a case-by-case basis and is analogous to the concept of “permanent establishment,” whereas the concept of “effectively connected” is analogous to the “attributable” notion under Article 7 of the OECD Model.²⁷

Generally speaking, there are four²⁸ categories of effectively connected income for Chilean corporations currently engaged in the conduct of a trade or business in the United States.²⁹ The first and second categories encompass investment income such as capital gains, fixed or determinable annual or periodical income, and certain other income that is treated similarly. As a consequence, investment income will be considered effectively connected if it satisfies tests (the asset use test and the business

22. L.I.R. art. 15.

23. L.I.R. art. 63.

24. See PAUL R. MCDANIEL ET AL., INTRODUCTION TO UNITED STATES INTERNATIONAL TAXATION 72 (Aspen Publisher 5th ed. 2005).

25. I.R.C. § 882.

26. I.R.C. § 881.

27. MCDANIEL ET AL., *supra* note 24, at 54.

28. There are actually five categories, but due to the similarities among capital gains and fixed or determinable, annual or periodical income, they are treated together for practical purposes.

29. I.R.C. § 864(c).

activity test) designed to determine whether they have sufficient economic nexus to the U.S. trade or business.³⁰ Fixed or determinable, annual or periodical income includes interest, dividends, rents, royalties, salaries and wages (in the case of individuals), premiums, annuities, and other forms of compensation.³¹

Third, capital gains derived from the disposal of U.S. real property investment are treated as if Chileco were engaged in a trade or business in the United States, and that gain is effectively connected to such trade or business.³²

Lastly, all other income not expressly included in the aforesaid categories is treated as effectively connected with the conduct of a trade or business in the United States under a limited force of attraction principle.³³

2. Taxation of Dividends

Dividends distributed from a Chilean corporation to USco are subject to the Additional Tax at a flat rate of 35 percent under Article 58(2) of the CITL. The tax is withheld by the Chilean corporation when the dividend is distributed.³⁴ The same treatment is generally granted to distributions from partnerships to non-resident partners.³⁵

The integrated Chilean system ensures that the dividend paid to the non-resident shareholder will not be subject to an effective income tax rate higher than 35 percent. This is also the reason claimed by Chile for including the so called “Chile Clause” in all of its tax treaties in order to not reduce the withholding tax on dividends since the 35 percent overall tax is considered sufficiently fair.³⁶

30. Jessica L. Katz, et al., U.S. Income Taxation of Foreign Corporations, 908-2nd Tax Mgmt. (BNA).

31. ROBERT MELDMAN & MICHAEL SCHADEWALD, A PRACTICAL GUIDE TO U.S. TAXATION OF INTERNATIONAL TRANSACTIONS 373–386 (Kluwer Law International 3rd ed. 2000).

32. I.R.C. § 897.

33. I.R.C. § 864(c)(3).

34. L.I.R. art. 74, No. 4.

35. L.I.R. art. 60.

36. For example, Article 10 of the Chile-U.S. Tax Treaty provides: “This paragraph shall not affect the taxation of the company’s profits out of which the dividends are paid.” In the case of Chile, this taxation includes the application of the additional tax. Convention Between the Government of the Republic of Chile and the Government of the United States of America for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital [hereinafter Chile-U.S. Tax Treaty], Chile-U.S., art. 10, Feb. 4, 2010, <http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/ChileTreaty2010.pdf>; see also Sandra Benedetto & Astrid Schudeck, *El Convenio para Evitar la*

On the other hand, Article 58 No. 1 of the CITL subjects permanent establishments and agencies to the same 35 percent tax on distributions to non-resident owners.

Under Article 21 of the CITL, loans granted by a partnership to its non-resident partners are taxable as distribution of profits if the SII considers that such loan is a disguised distribution of profits.³⁷ In the case of a corporation, if the same conditions are met, a flat tax of 35 percent is applied to that distribution.³⁸

In contrast, as a general rule, a 30 percent tax is applied on dividends paid by a U.S. corporation to Chileco under section 881 of the I.R.C.³⁹ Nevertheless, if the income from which the dividend arises is at least 80 percent from non-U.S. source, an exemption is granted to the non-resident recipient of the dividend if certain conditions are met.⁴⁰ The term “dividends” is broadly defined under the I.R.C. and Regulations to include distributions by corporations from current retained earnings and profits and substitute payments that are derived from the ownership of stocks.⁴¹

Under section 884 of the I.R.C., a branch profit tax of 30 percent is applied to foreign corporations on a dividend equivalent amount for the taxable year, granting a similar tax treatment to distributions of profits from branches as that applied to subsidiaries.⁴² Although the term “dividend equivalent amount” aims to be analogous to a tax on dividends, it has a different basis. Indeed, section 884 (b) and (c) of the I.R.C., defines this term as Chileco’s effectively connected earnings and profits for the taxable year adjusted by differences on the U.S. net equity (U.S. assets minus U.S. liabilities) of the foreign corporation as of the close of the preceding taxable year and the U.S. net equity of the foreign corporation as of the close of the taxable year.⁴³

Doble Imposición: Tratamiento aplicable a los Dividendos [The Chile-U.S. Tax Treaty: Taxation of Dividends], 1 SERIE DE ESTUDIOS TÉCNICOS AMCHAM 9, 12 (2010) (Chile).

37. L.I.R. art. 21, ¶ 1.

38. *Id.*

39. I.R.C. § 881(a).

40. The income must arise from the active conduct of business in a foreign country for the three-year period ending with the close of the taxable year of the individual or corporation preceding the payment. *See* I.R.C. §§ 871(i)(2), 881(d).

41. *See generally* BORIS I. BITTKER & LAWRENCE LOKKEN, FUNDAMENTALS OF INTERNATIONAL TAXATION ¶ 67.2.3, at 67–20 (Warren, Gorham & Lamont ed. 2005–2006).

42. I.R.C. § 881(b).

43. I.R.C. § 881(c).

3. Taxation of Interest

Under Article 59 of the CITL, interest on loans made by USco to a resident company or individual is currently taxed at 35 percent. Interest is considered to be sourced in Chile if the debtor is domiciled in Chile.⁴⁴ This rate is reduced to 4 percent on interest arising from certain types of credits or debt instruments.⁴⁵

A total exemption from Additional Tax is granted to interest obtained by foreign bank or financial institution lenders that grant a loan to a Chilean financial institution that in turn loans the principal abroad.⁴⁶

Thin capitalization rules were enacted in 2001⁴⁷ to restrict the application of the 4 percent tax rate when loans are granted between related parties, especially in connection with back-to-back arrangements. Parties are deemed to be related if: (a) the lender is domiciled or incorporated in a jurisdiction considered to be a tax haven; (b) the lender directly or indirectly owns or holds 10 percent or more of the borrower's capital or profits; (c) the lender and the borrower⁴⁸ are owned by a common shareholder that directly or indirectly owns or holds 10 percent or more of the capital or profits of both; and (d) the financing has been granted with a direct or indirect guarantee from a third party in cash or valuables, up to the amount effectively guaranteed in this manner.⁴⁹

This rule provides that an additional 31 percent is levied on a portion of the interest paid if the total amount of the related borrowing is in excess of an objective debt to equity ratio of 3:1.⁵⁰

44. L.I.R. art. 10.

45. In accordance with Article 59 of L.I.R., the following transactions benefit from the 4 percent tax rate: (i) credit extended abroad by foreign or international banks or financial entities, insurance companies or foreign pension funds registered in accordance with Article 106 of L.I.R.; (ii) interest paid from publicly traded debt instruments in accordance with Article 104; (iii) balances (unpaid portions) on the price of imported goods; (iv) interest payments arising from bonds or debentures issued by the Chilean government and the Chilean Central Bank; (v) interest paid on deposits made in foreign or local currency accounts made with Chilean institutions duly authorized by the Chilean Central Bank; and (vi) interest on Latin American Banking Acceptances made by members of the Latin American Integration Association (ALADI). L.I.R. art. 59.

46. L.I.R. art. 59, ¶ 4, No. 1(b).

47. Law No. 19.738 (2001) (Chile).

48. In accordance with Article 59, number 1, paragraph 7(e) of the L.I.R., thin capitalization rules do not apply in cases where the debtor is engaged in financing activities and is recognized as a financing institution by the Ministry of Finance. L.I.R. art. 59, No. 1, ¶ 7(e).

49. L.I.R. art. 59, ¶ 4, No. 1, ¶ 3(c).

50. S.I.I., Circular No. 24, Mar. 14, 2002 (Chile), <http://www.sii.cl/documentos/circulares/2002/circu24.htm>.

It is important to point out that the difference (31 percent) between the tax rate effectively paid (35 percent) and the reduced tax applicable (4 percent) will be borne by the payor related company and, therefore, it could be accepted as an expense to decrease its taxable income under Article 31 of the CITL.⁵¹

Current thin capitalization rules included in the CITL encourage investment through debt instead of equity because, from the economic perspective of foreign investors, both the interest⁵² and the 31 percent tax difference are deductible expenses, thereby decreasing the Chilean subsidiary's taxable income.⁵³

From the standpoint of tax policy, this tax treatment was enacted in 2001 as a response to the need to attract FDI to a developing country.⁵⁴ Nevertheless, with Chile's current economic situation and the expectation that the country can become a developed country by 2018,⁵⁵ it is unclear whether such policy is optimal for Chile in the near future because it deflects revenue to the country in which the non-resident company is established, consequentially reducing Chilean revenue that could be targeted to other objectives.⁵⁶

51. L.I.R. art. 59, No. 1, ¶ 3(e).

52. Articles 37 and 38 of the L.I.R. provide rules that require an arm's length price on the interest charged between related parties, but it does not provide rules related to debt that partakes of business risk. L.I.R. arts. 37–38.

53. A stamp tax with a rate of up to 0.6 percent of the total amount borrowed may be assessed on this loan, and transfer pricing rules under Article 38 of the L.I.R. may apply to decrease the amount of interest paid to the non-resident. Therefore, all factors must be considered to make a final decision as to the most convenient form of investment. L.I.R. art. 38.

54. Law No. 19.738, *supra* note 47.

55. The Finance Minister, Felipe Larraín, estimates that Chile will become a developed country in 2018 if GDP grows at an annual rate of 6 percent. If this occurs, the country will achieve a GDP per capita of USD\$ 22,000, similar to that of Portugal. It is important to bear in mind that the term “developed country” is not altogether clear, and major global institutions (e.g., the World Bank, OECD, and U.N.) do not agree on a specific definition. *See*, Chile Pretende Llegar en 2018 al Nivel de Riqueza del Mundo Desarrollado (*Chile in 2018 Aims to Reach the Level of Wealth of the Developed World*), THIS IS CHILE (May 28, 2010), <http://www.thisischile.cl/Article.aspx?id=4176&sec=288&ej=&t=chile-pretende-llegar-en-2018-al-nivel-deriqueza-del-mundo-desarrollado&idioma>; Felipe Larraín, Chile Pretende Llegar en 2018 al Nivel de Riqueza del Mundo Desarrollado, <http://www.thisischile.cl/Articles.aspx?id=4176&sec=288&ej=&t=chile-pretende-llegar-en-2018-al-nivel-deriqueza-del-mundo-desarrollado&idioma> (last visited Nov. 1, 2010).

56. This legislation was intended to reduce the cost of financing internationally, since most lenders simply added the tax withheld in the payor's country to the interest rate applicable to the loan using a gross-up clause. The

From a U.S. perspective, interest from a U.S. source paid to Chileco is subject to a 30 percent withholding tax under section 871 of the I.R.C.⁵⁷ Similar to Chile, interest is generally sourced according to the residence of the payor; hence any interest paid by a U.S. corporation to a corporate non-resident of the United States is considered U.S. source interest by the federal government.⁵⁸ However, the I.R.C. includes an important exception.⁵⁹ If Chileco makes deposits with a foreign branch of a U.S. corporation or a U.S. partnership, if such branch is engaged in the commercial banking business, interest arising from such deposits will be tax exempt in the United States.⁶⁰

On the other hand, the I.R.C. provides specific exemptions for certain types of interest. Interest paid from a portfolio investment to Chileco is exempt from the 30 percent withholding tax.⁶¹ For these purposes, portfolio interest is any U.S. source interest other than interest effectively connected with the conduct of a U.S. trade or business paid or accrued on debt obligations issued after July 8, 1984.⁶² The I.R.C. also provides an exemption for interest on bank deposits and similar arrangements held by an insurance company under an agreement to pay interest.⁶³

With respect to thin capitalization rules, section 385 of the I.R.C. allows regulations classifying obligations as debt in part and equity in part.⁶⁴ However, no regulations under this provision have yet been proposed; hence, main issues on this topic are solved based on case law and revenue rulings taking into consideration that a high debt to equity ratio suggests that purported debt is equity because a holder of the corporation's debt is not protected by the equity cushion typically enjoyed by a debt holder and thus bears risks more like those of a shareholder.⁶⁵

deflection of revenues is derived from the fact that this interest is likely to be subject to tax in the country where the lender is domiciled.

57. I.R.C. § 871(a)(1)(A).

58. RICHARD L. DOERNBERG, INTERNATIONAL TAXATION 29 (Thomson West 6th ed. 2004).

59. I.R.C. § 861(a)(1)(B).

60. The Education, Jobs, and Medicaid Assistance Act, Pub. L. No. 111-226, enacted on August 10, 2010 repealed another benefit associated with interest paid by a U.S. Corporation that obtains at least 80 percent of its gross income from non-U.S. trade or business, in which case none of the interest paid to a non-resident was subject to taxes in the United States *See also* DOERNBERG, *supra* note 58, at 30.

61. I.R.C. §§ 871(h)-1444(c)(9).

62. *See* MELDMAN & SCHADEWALD, *supra* note 31.

63. I.R.C. §§ 871(i)-881(i)(3)(c).

64. I.R.C. § 385. *See* PAUL R. MCDANIEL ET AL., FEDERAL INCOME TAXATION OF CORPORATIONS 147-156 (Foundation Press 2d ed. 2001).

65. *Id.*

4. *Taxation of Royalties*

Payments derived from the use in Chile of trademarks and other analogous rights owned by USco related to industrial and intellectual property are deemed to be sourced in Chile.⁶⁶ In accordance with Article 59 of the CITL, income from these royalties is subject to a 30 percent withholding tax at source.⁶⁷ However, the rates of the applicable Additional Tax may vary depending on the nature of the intangible asset that generates the income.⁶⁸ The 30 percent rate is reduced to 15 percent when royalties are paid for the use or the right to use software or other intellectual property in connection with a computer or a processor. However, if payments are made to a related party, the tax rate is increased to 20 percent.⁶⁹

Deductions for royalty payments to USco are generally fully deductible if they are deemed necessary to produce income for the recipient of the intellectual property.⁷⁰ However, the CITL provides that the deductions will be limited to up to 4 percent of the payor's gross income when payments are made to a non-resident unless the non-resident is not related to the payor of the royalty or — if related — unless the income derived from the royalty payments is subject to an income tax rate equal to or greater than 30 percent.⁷¹ Consequently, given the current corporate tax rate in the United States, royalty payments to USco should not be subject to the aforesaid limitation on deductions.

From a U.S. perspective, royalties arising from property or interests located in the United States owned by Chileco are deemed U.S. source taxable at a 30 percent withholding rate under section 861.⁷² Since the location of the intangible property can be an arguable issue, the I.R.C. determines that the use or privilege of using patents, copyrights, secret processes and formulae, goodwill, trademarks, trade brands, franchises, and

66. L.I.R. art. 10, ¶ 2.

67. L.I.R. arts. 59, 74, 79.

68. The rates included in (i) above can be raised up to 80 percent if the President of Chile considers that the intangible asset is unproductive or not necessary for the country's economic progress. Additionally, the L.I.R. applies a 20 percent tax rate on the total amount paid to non-resident producers and/or distributors for material shown in theaters or on television and a 15 percent tax rate on copyrights paid to non-residents.

69. One party is deemed to be related to another if the recipient of the payments owns 10 percent or more of the equity or the right to profits of the payer of the royalties or if both recipient and payor are under a common partner that directly or indirectly owns 10 percent or more of the equity or right to profits of each company. L.I.R. art. 59, ¶ 4, No. 1.

70. L.I.R. art. 31, No. 1.

71. L.I.R. art. 31, No. 12.

72. I.R.C. § 861(a)(4).

the like within the United States is equivalent to the intangible property being located within the United States.⁷³ Payments considered to be contingent on the productivity of the intangible asset are treated as royalties rather than capital gains.⁷⁴

The allocation of expenses must respect the arm's length standard under section 482 and its regulations on transfer pricing; however, this topic is highly litigated in courts due to the disparity in criteria between the I.R.S. and taxpayers.⁷⁵ For instance, a conflict over transfer pricing between the I.R.S. and the multinational pharmaceutical giant GlaxoSmithKline resulted in a USD\$ 3.7 billion settlement, putting an end to the largest tax conflict in U.S. history.⁷⁶

The main conflict regarding transfer pricing arises from the particularity of the intellectual property.⁷⁷ Given the innovative or unique nature of intangibles, which is their essence, comparables generally do not

73. Joseph Isenbergh, *Foundations of U.S. International Taxation*, 900-2nd Tax Mgmt. (BNA) Ch. I, Sec. H.

74. *Id.*

75. For example, in *Eli Lilly Co. v. Commissioner*, 856 F.2d 855 (7th Cir. 1988), a U.S. parent company constituted a subsidiary in Puerto Rico to which it transferred patents and know-how. This subsidiary in turn manufactured a medication and sold the product to its parent company.⁷⁵ The I.R.S. decided that the price charged for the assets transferred by the parent company was insufficient, and, thus, the parent company's profits should be increased. The United States Tax Court decided to use the Residual Profit Split Method, allocating the revenue from manufacturing and renting the facilities in Puerto Rico to its subsidiary and the expenses related to marketing the product in the United States to the parent company. It then allocated the residual profit between the parent company and subsidiary in a 45/55 proportion. The problem with the decision adopted by the court was that no basis was provided for this proportion of the parent's transfer of patents and manufacturing know-how to its subsidiary in exchange for stock in the subsidiary. In a similar case, *Hospital Corp. v. Commissioner*, 81 T.C. 520 (T.C. 1983), the United States Tax Court ruled that the combined profits from the U.S. parent company and its subsidiary in the Cayman Islands should be distributed 75 percent for the former and 25 percent for the latter. These parameters were not based on objective criteria, but rather a subjective estimate by the court, which calculated that the contribution of personnel, know-how, experience, and contract negotiation assistance was worth three-fourths of the business's profits. See also the United States Tax Court's decision in *Bausch & Lomb Inc. v. Commissioner*, 92 T.C. 525 (T.C. 1989), in which the court decided to divide the business's profits from the production of contact lenses in equal parts without providing grounds for the criteria used for this division.

76. *IRS Accepts Settlement Offer in Largest Transfer Pricing Dispute* IR-2006-142 (Sept. 11, 2006), <http://www.irs.gov/newsroom/article/0,,id=162359,00.html>.

77. Yariv Brauner, *Value in the Eye of the Beholder: The Valuation of Intangibles for Transfer Pricing Purposes*, 28 VA. TAX REV. 79 (2008).

exist and, when they do exist, there is no reliable information for determining their price.⁷⁸

Considering that research and development (“R&D”) might considerably reduce U.S. source income and not affect foreign source income — and related tax credits — the United States has a mixed system of legal and geographical deductions together with a formulary apportionment based on sales or gross income in order to allocate R&D expenses among parent and subsidiaries related to the production and exploitation of the intangible.⁷⁹

For instance, if Chileco must incur R&D expenses to meet legal requirements imposed by a food, drug, safety or compliance institution, or any similar entity, such expenses are exclusively allocated to the country that imposes such requirements.⁸⁰ The remaining expenses are allocated as follows: 50 percent to the location where most of the expenses were incurred and the remaining 50 percent under a formula based on the ratio of U.S. sales to worldwide sales.⁸¹ Alternatively, the regulations permit 25 percent of R&D to be allocated to the place where the expenses were materialized, and the remainder can be apportioned based on the ratio of U.S. gross income to worldwide income.⁸² However, this is applicable only to the extent that the result of the apportionment is at least 50 percent of the result under the sales method.⁸³

5. *Taxation of Capital Gains*

In accordance with the CITL, the general rule is that gains realized by USco on Chilean capital assets are subject to the First Category Tax with a 20 percent tax rate and the Additional Tax with a 35 percent tax rate.⁸⁴ As mentioned above, the former can be credited against the latter.

A capital gain is deemed realized in Chile if the capital asset is located in the country.⁸⁵ As a result, if USco sells shares in corporations and interests in partnerships established under the laws of Chile at a gain, such income will be taxable in Chile.⁸⁶ If USco has held its stock for more than one year, the capital gain realized on the sale of those shares is subject to the

78. *Id.*

79. I.R.C. § 864(f).

80. *See* DOERNBERG, *supra* note 58, at 66.

81. Reg. § 1.861-17(c).

82. Reg. § 1.861-17(b); MCDANIEL ET AL., *supra* note 24, at 50.

83. *See* DOERNBERG, *supra* note 58, at 67.

84. L.I.R. art. 20, Nos. 2–5; art. 60.

85. L.I.R. art. 10.

86. L.I.R. art. 10, ¶ 1.

First Category Tax as a sole tax.⁸⁷ However, if USco is engaged in selling shares on a habitual basis, or if it sells the stock to a related party,⁸⁸ the Additional Tax is applied in addition to the First Category Tax.⁸⁹

The CITL also taxes gains from the sale of shares or interest in a foreign entity made by USco to an individual or entity established under the laws of Chile. This gain is sourced in Chile if the acquisition permits direct or indirect participation in the equity or profits of a corporation or partnership established under Chilean law.⁹⁰

Furthermore, the CITL provides several exemptions for capital gains. For instance, gains from American Depositary Receipts (ADRs)⁹¹ and *cuotas* (or units) of Chilean investment funds are exempted of taxes if at least 90 percent of the underlying assets are invested outside of Chile.⁹² In addition, capital gains realized on sales of stocks, debt instruments, investment fund units, and mutual fund units that are publicly traded by a non-resident institutional investor, such as a foreign investment fund, mutual fund or pension fund, are also exempted.⁹³ In order to access this benefit, the non-resident institutional foreign investor must meet a series of additional registration and reporting requirements.⁹⁴

However, the most important exemption for capital gains is granted to both residents and non-residents with respect to gains on the sale of issued

87. A similar tax treatment is granted to alienation of mining rights when they do not form part of the asset registry of a company that has full accounting in Chile and is taxable under the First Category Tax, intellectual property when it is sold by its inventor or author, alienation of rights in a mining company, and alienation of bonds or debentures. L.I.R. art. 17, No. 8.

88. In accordance with paragraph 4 of Article 17 of the L.I.R., a transaction is deemed to be made with a “related person” if it is made by a partner or shareholder of a company and the company in which he or she has an interest. The S.I.I. has ruled that this interest is of an economic nature and does not include a family relationship. S.I.I., Oficio No. 3150, Nov. 12, 1996 (Chile), <http://home.sii.cl/sacn/oficios/JA0328.pdf>.

89. L.I.R. art. 17, No. 8(a); art. 10.

90. However, this source rule will not apply if this transaction does not result in the acquisition of more than 10 percent of the equity or profits of the “target” Chilean entity. If the Chilean acquirer and the acquired company are under a common shareholder — direct or indirect — participation in the equity or profits of the acquired company must also not exceed 10 percent to avoid application of this provision. L.I.R. art. 10, ¶ 2.

91. L.I.R. art. 11, ¶ 3.

92. *Id.*

93. L.I.R. art. 106.

94. See L.I.R. art. 106, §§ 1, 2, 3, 4, 5, 6 and 7 for a detailed list of the requirements.

shares of publicly traded corporations, investment funds, and mutual funds that are actively traded and sold on the Chilean stock market.⁹⁵

Finally, a capital gain on immovable property is not taxable for USCo if the real estate or rights in real estate held with others do not form part of the asset registry of a company that has full accounting in Chile and is taxable under the First Category Tax.⁹⁶ However, the taxation on capital gains will be triggered if either of the following conditions are met: (a) the sale is made to a related person or (b) USCo is engaged on a habitual⁹⁷ or regular basis in real estate transactions.⁹⁸

Conversely, in accordance with section 865 of the I.R.C., income from the sale of personal property by Chileco is sourced at its residence; therefore, as a general principle, a sale of personal property made by a Chilean resident will be exempt of taxes in the United States.⁹⁹

Nevertheless, this general rule has several exceptions. For instance, gain arising from the sale of inventory, which is sourced at the place where the sale occurred.¹⁰⁰ Nevertheless, if the capital gain arises from the sale of property attributable to an office or fixed place of business located abroad, it is treated as foreign source if the foreign country imposes at least a 10 percent tax on income from such sale.¹⁰¹

In accordance with the I.R.C., if Chileco sells depreciable property at a gain, it is sourced in the United States if the depreciation deduction was

95. To apply this tax exemption, the following requirements must be met: (i) the sold shares or units must be of a publicly-held corporation with a “stock exchange presence.” For this purpose, “stock exchange presence” means that the total daily transactions of these securities exceeded approximately USD\$ 9,000 for at least 45 business days within the last 180 business days; (ii) the sale must take place on a Chilean stock exchange approved by the Chilean Securities and Exchange Commission (“SVS”) or in a public offer to buy shares under the procedure regulated by the Securities Law; and (iii) the shares must have been acquired on a stock exchange, in an initial public offering when a company incorporated or increased its capital, in an exchange of convertible bonds, or in a redemption of the underlying assets of an exchange traded fund. L.I.R. art. 107.

96. L.I.R. art. 17, No. 8(b).

97. See Oficio No. 1693 of 2002 for elements used by the S.I.I. to determine whether the seller is habitual. S.I.I., Oficio No. 1693, May 29, 2002 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2002/renta/ja294.htm>.

98. Pursuant to Article 18 of the L.I.R., if USCo sells the property within one year of acquisition of the property or four years from the date of acquisition if the property has been subdivided, the taxpayer will be considered habitual whether or not he is engaged in the real estate trade or business. L.I.R. art. 18.

99. I.R.C. §§ 865(a)–(b).

100. See MCDANIEL ET AL., *supra* note 24, at 41; *see also* Reg. § 1.861-7(a) (providing that a sale of personal property is consummated at the time when and the place where the rights, title, and interest of the seller in the property are transferred to the buyer).

101. See DOERNBERG, *supra* note 58, at 47; *see also* I.R.C. § 865(e).

used against income sourced in the United States¹⁰² Payments on the sale of intangible property owned by Chileco that are contingent on the productivity, use, or disposition of the intangible are sourced and taxable as royalties rather than capital gain.¹⁰³

Gain realized by Chileco from the disposition of a United States Real Property Interest (“USRPI”) is sourced in the United States.¹⁰⁴ A USRPI is defined in very broad terms including an interest in real property located in the United States or the Virgin Islands; shares in U.S. corporations that own a sufficient U.S. real property interest to satisfy an asset ratio test (more than 50 percent) on certain testing dates; and equivalent interest in a foreign corporation that directly or indirectly (through other entities) owns real property situated in the United States.¹⁰⁵

Finally, if — instead of Chileco — the capital gain is accrued directly by a Chilean individual that is not a resident of the United States,¹⁰⁶ such gain can still be exempted of taxes if he does not meet the presence test described in the I.R.C.¹⁰⁷ Under this test, if a non-resident alien is physically present in the United States for at least 183 days during a taxable year, he is subject to a 30 percent tax on the excess of U.S. source gains over capital losses allocable to U.S. sources.¹⁰⁸

6. Current Withholding Tax on FDI

The following table illustrates the current withholding tax on USD\$ 100 in profits — after corporate tax — for both Chileco and USco of a classic investment structure in a wholly-owned manufacturing subsidiary in each country from which 40 percent of the profits are remitted as dividends; 30 percent as interest from a regular loan; 20 percent as royalties derived from the use of software; and 10 percent as payments for services provided by the parent in the subsidiary’s country.¹⁰⁹

102. I.R.C. § 865(c)(1)(A)–(B).

103. I.R.C. § 865(d)(1)(A)–(B).

104. I.R.C. § 861(a)(5).

105. I.R.C. § 897(c).

106. In contrast, see I.R.C. § 861(5)(f), ruling that a gain realized by a U.S. resident on a foreign corporation is sourced in the United States if more than 50 percent of the gross income is not derived from active trade or business outside of the United States for the last three years preceding the year in which the sale took place.

107. I.R.C. § 871(a)(2).

108. See BITTKER & LOKKEN, *supra* note 41, ¶ 67.2.10, at 67–42.

109. The percentages used to illustrate the applicable tax burden are based on the author’s experience with general international investment structures in each country.

Chileco's Investment in the U.S.				USco's Investment in Chile			
Type of Payment	Amount in U.S. Dollars	Tax Rate	Tax	Type of Payment	Amount in U.S. Dollars	Tax Rate	Tax
Dividends	40	30%	12	Dividends	40	15% ¹¹⁰	6
Royalties	30	30%	9	Royalties	30	30%	9
Interest	20	30%	6	Interest	20	35%	7
Services	10	30%	3	Services	10	20%	2
Total	100		30	Total	100		24

As the table illustrates, the current withholding tax on investment income is a fixed rate in the United States, but it varies in Chile depending on the type of income that creates opportunities for advanced tax planning techniques.¹¹¹ The following section will review the impact of the Treaty on current withholding tax to analyze its potential effect on reciprocal FDI.

III. THE CHILE-U.S. TAX TREATY

The objective of limiting double taxation is generally accomplished in treaties by each country agreeing to limit, in certain specified situations, its right to tax income earned from its territory by residents of the other country.¹¹² For the most part, the various rate reductions and exemptions by the source country provided in the treaties are premised on the assumption that the country of residence will tax the income in any event at levels comparable to those imposed by the source country on its residents.¹¹³

1. *Historic Background*

The first tax treaty signed by Chile was the Convention Between Chile and Argentina for the Avoidance of Double Taxation signed in 1976

110. This rate is calculated as the difference between the Additional Tax of 35 percent and the current First Category Tax of 20 percent.

111. This effect is even greater if the structure includes a back-to-back scheme that reduces the withholding tax on interest to 4 percent. As mentioned in Section II.3, this type of structure is accepted by the L.I.R. if it meets the objective 3:1 debt/equity ratio.

112. Dagan, *supra* note 9, at 364.

113. However, this objective is not always achieved because the resident country is not obligated to tax income that was tax exempt in the source country. Michael Lang, *General Report on Double Non-Taxation*, 89a CAHIERS DE DROIT FISCAL INT'L (2004) (Austria) (explaining that this consequence is an example of a treaty causing double non-taxation for the taxpayer).

and in force since 1986.¹¹⁴ This treaty follows the exemption method as a system to avoid double taxation and uses as a reference a model from the Andes Pact (*Pacto Andino*),¹¹⁵ although, it also has several sourcing rules of its own.¹¹⁶ Since the signing of this convention, all treaties signed by Chile have mainly been based on the OECD Model Tax Convention on Income and Capital (OECD Model).¹¹⁷ This model was created in 1963 and, together with its commentaries, has been updated several times, the last of which occurred in 2010.¹¹⁸

On the other hand, while a member of the OECD, the United States opted to promulgate its own model in 1981, which was modified in 1996 and 2006, including its technical explanations.¹¹⁹ This model is substantially similar to the OECD model. However, it contains several differences that affect the taxation of business and investment income, including differences in withholding rates, the power of taxation of the United States with respect to its citizens without regard to their residence (“saving clause”), and provisions related to the limitation of benefits.¹²⁰

114. *See* Convenio entre la República de Argentina y la República de Chile para Evitar la Doble Tributación en Materia de Impuestos Sobre la Renta, Ganancia o Beneficio y Sobre el Capital y el Patrimonio [Agreement for the Avoidance of Double Taxation Between Argentina & Chile], Arg.-Chile, Nov. 13, 1976, <http://www.sii.cl/pagina/jurisprudencia/convenios/chileargen.htm>

115. COMM’N OF THE CARTAGENA AGREEMENT [CCA] Decision 40 (1971) *reprinted in* ORDENAMIENTO JURIDICO DE ACUERDO CARTAGENA, DECISIONES 1–90, 110–30 (Junta del Acuerdo de Cartagena, 1982), <http://www.comunidadandina.org/ingles/normativa/d040e.htm> (Approval of the agreement among member countries to avoid double taxation and of the standard agreement for executing agreements on double taxation between member countries and other states outside the subregion).

116. RIVAS NORBERTO, DOBLE TRIBUTACIÓN INTERNACIONAL [DOUBLE INTERNATIONAL TAXATION] (2002) (Chile).

117. *See* OECD, *supra* note 10.

118. The 2010 update included changes to the attribution of profits for permanent establishments, tax benefits for collective investment vehicles, and other minor issues related to telecommunication services and employment income. *See* OECD, THE OECD APPROVES THE 2008 UPDATE TO THE MODEL TAX CONVENTION, http://www.oecd.org/document/32/0,3746,en_2649_33747_45689952_1_1_1_1,00.html (last visited June 29, 2011).

119. U.S. Treasury UNITED STATES MODEL TECHNICAL EXPLANATIONS ACCOMPANYING THE UNITED STATES MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 [hereinafter U.S. 2006 MODEL TECHNICAL EXPLANATIONS], in MARTIN B. TITLE & REUVEN S. AVI-YONAH, THE INTEGRATED 2006 UNITED STATES MODEL INCOME TAX TREATY 255-350 (Vandeplas Publishing ed. 2008).

120. *See* MARTIN B. TITLE & REUVEN S. AVI-YONAH, THE INTEGRATED 2006 UNITED STATES MODEL INCOME TAX TREATY 1–199 (Vandeplas Publishing ed. 2008).

U.S. tax treaty policy has not made South America a priority. In fact, of the sixty-seven tax treaties that the United States currently has in force with countries throughout the world, the Venezuelan and Mexican treaties are the only agreements currently in force with Latin American countries.¹²¹ The reasons for the limited U.S. tax treaty network in Latin America are not altogether clear but, in this author's opinion, it is likely based on two facts: (i) the strong exchange of information requirements imposed by the United States as a basic condition to start tax treaty negotiations is considered inappropriate interference with secrecy laws and, as a result, with the sovereignty of most Latin American countries; and (ii) the relatively small investment by Latin American countries in the United States together with relevant political differences between this country and several other countries in the region do not create an appropriate incentive to the United States to move forward with the process of tax treaty negotiation.

2. *Treaty Negotiations*

The negotiations process for the Treaty, which is still pending approval from both congresses, lasted over ten years.¹²² The main reason for such lengthy negotiations is that the United States required a stricter policy regarding the exchange of information and considered Chile's secrecy laws in appropriate for achieving the desired level of interaction between tax authorities.¹²³

At the same time, the OECD declared that a series of adjustments needed to be made to the Chilean tax system, especially in regards to bank secrecy limits on tax matters and policies on the exchange of information by tax authorities. In response, the Chilean Congress passed Law No. 20,406, amending Article 62 and adding new Article 62 *bis* to the Tax Code.¹²⁴ This law permitted the SII to request information on certain banking transactions, including any data subject to bank secrecy, as required to verify the veracity, completeness or omission of tax returns. This power is also conferred in

121. U.S. Income Tax Treaties – A to Z, <http://www.irs.gov/businesses/international/article/0,,id=96739,00.html> (last visited Aug. 22, 2011). The first tax treaties entered by the United States were with France and Sweden in 1939. With respect to other Latin American countries, the United States terminated a tax treaty with Honduras in 1966 and is prompted to start a tax treaty negotiation with Brazil. See Press Release of Senator Lugar, <http://lugar.senate.gov/news/record.cfm?id=332042&&> (last visited Oct. 24, 2011).

122. The first round of meetings began in December 1999 and finished in December 2009. See José Madariaga, *Convenio para Evitar la Doble Imposición entre Chile y Estados Unidos. Aspectos Generales* [*The Chile-U.S. Tax Treaty: General Issues*], 2 REVISTA DE ESTUDIOS TRIBUTARIOS 183, 185 (2010).

123. *Id.*

124. Law No. 20.406 (2009) (Chile).

cases where such information is requested of the SII by administrative authorities from other countries with which Chile has signed international conventions — either specific agreements on this issue or general income tax treaties — that allow such requests.¹²⁵ Once Law No. 20,406 was published, as part of Chile's accession effort to the OECD, Treaty negotiations moved forward rather quickly since the main barrier to enactment was eliminated.

Despite the existence of a model to negotiate tax treaties, it is important to point out that countries are usually willing to modify their tax policies to grant concessions to a country treaty partner when such concessions are not deemed to have a large impact on revenues.¹²⁶

From a tax policy perspective, when Chile negotiates a tax treaty with both developed and developing countries, some elements of the United Nations Model Double Taxation Convention between Developed and Developing Countries of 2001 (“U.N. Model”) are also included in the final treaty version, which basically increases the authority of the developing country to tax certain income arising in the source country.¹²⁷ These modifications attempt to strike a balance between the losses of revenues of the contracting states as a result of signing a tax treaty.¹²⁸

For instance — and considering that determination of the dynamic effect of taxes on investment is highly complex — since Chilean FDI in the United States is less than U.S. FDI in Chile,¹²⁹ the cost to Chile of allowing exemptions or reducing tax rates on business and investment income might

125. See CÓDIGO TRIBUTARIO [C.T.] [Tax Code] arts. 62 and 62bis (Chile).

126. For example, in the case of the U.S.-Mexico tax treaty, the rental of most commercial, scientific, or industrial equipment that does not constitute immovable property is included in the definition of a royalty. Hence, the right to tax that income is shifted to the country in which the tangible property is located, which will generally be the developing country (Mexico). See Convention Between the Government of the United States of America and the Government of the United Mexican States for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, U.S.-Mex., art. 12(3), Sep. 18, 1992 [hereinafter U.S.-Mex. Tax Treaty]; see also TREA. DEP'T, Technical Explanations of this Treaty, ¶ 13 (1992).

127. U.N. DEP'T OF INT'L & SOC. AFFAIRS, UNITED NATIONS MODEL DOUBLE TAXATION CONVENTION BETWEEN DEVELOPED AND DEVELOPING COUNTRIES 382, U.N. Doc. ST/ESA/PAD/SER.E/21, U.N. Sales No. E.01.XVI.2 (2001).

128. Bart Kusters, *The United Nations Model Tax Convention and Its Recent Developments*, ASIA-PAC. TAX BULL., Jan.-Feb. 2004, at 4, <http://unpan1.un.org/intradoc/groups/public/documents/UNPAN/UNPAN014878.pdf>.

129. See EL MERCURIO, *supra* note 1.

be higher than the reciprocal benefits granted by the United States to Chilean business or investments.¹³⁰

As explained below, the impact on Chilean revenues derives from the direct reduction of withholding taxes and from the fact that such reduction has an even greater impact since it has a collateral effect on other treaties — especially those signed with other OECD members — due to the application of the most favored nation clause.¹³¹ Under this clause — included in most treaties signed with OECD countries — Chile is obligated to grant other OECD members the same reduced withholding rates on dividends, interests, and royalties as those granted to the United States. As a consequence, the tax expenditures related to the Treaty must not be measured only considering the direct effect on taxation of U.S. investment, but they have to also consider the effect of the reduction of the withholding tax on income obtained by other OECD Members in Chile.

This is a relevant and complex topic for Chile considering its recent OECD membership because it presents the challenge of a country that has aspirations of becoming a developed country but has not yet reached that level. As explained below, this intermediate position has forced Chile to present several reservations in most tax provisions on investment income and arbitration clauses included in the OECD Model, showing that Chile is still preserving the source-country position over the residency-country position as of 2010.

As described in section 7.1 below, the most important concession made by the United States to Chile was most likely the granting of tax authority to the source country in the event of certain capital gains.¹³² It is important to bear in mind that this concession has only been granted by the United States in very limited cases (e.g., Article 13 of the U.S.-India Tax Treaty). This issue is extremely relevant for Chile because, due to the low corporate tax in Chile (20 percent), many times profits are not distributed to the non-resident shareholder to defer the Additional Tax. As a consequence, if the capital gain is exempted of tax as in most tax treaties signed by the United States, the deferral can become a permanent saving for the foreign investor.

From a Chilean perspective, the reduction of withholding tax on interest (from 15 percent to 10 percent) and certain royalties (up to 2 percent)

130. For more on the subject, see Hugo A. Hurtado, *Is Latin American Taxation Policy Appropriate for Promoting Foreign Direct Investment in the Region?*, 31 NW. J. INT'L L. & BUS. 313 (2011).

131. The most favored nation clause is included in thirteen tax treaties signed by Chile and its main purpose is to grant similar reduced rates on dividends, interest, and royalties included in new tax treaties to countries that have previously signed tax treaties with Chile.

132. Interview with Liselott Kana, Head of International Taxation, S.I.I., in Santiago, Chile (Oct. 5, 2011).

seems to be the most relevant concession upon comparison with other treaties. As explained above, this apparently minor reduction of the withholding tax on interests and royalties represents an important concession by Chile to the United States, not only for its relevance to the Treaty but also for the effect on other treaties signed by Chile with other OECD members under the most favored nation clause.

The following sections will review the main provisions applicable to investment income in order to determine the Treaty's potential impact on both FDI and fiscal revenues.

3. *Taxation of Business Profits in the Treaty*

Business profits are defined in paragraph 9 article 7 as income from any trade or business.¹³³ Article 7 of the Treaty establishes two requirements in order to enable the host country to tax the business profit income of a resident from a contracting state doing business in the source country: (i) the enterprise of the resident state must carry on business in the source country through a permanent establishment; and (ii) the income must be attributable to that permanent establishment.¹³⁴

3.1 *Permanent Establishment*

A PE is defined in Article 5 of the Treaty as a fixed place of business through which the business of an enterprise is wholly or partly carried on. The term PE includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources.¹³⁵

The Treaty follows the U.N. Model rather than the OECD and the U.S. Model with respect to the length of time required for a building site or construction or installation project to constitute a permanent establishment, fixing such time at six months rather than twelve months.¹³⁶ Furthermore, the Treaty reduces to three months the time required for a natural resource installation to create a PE.¹³⁷ Additionally, and in accordance with the reservations expressed by Chile in the OECD Commentaries to the Model Tax Convention (the "Commentaries"), the Treaty sets forth that the performance of services constitutes a PE if they are rendered for a period or periods exceeding, in the aggregate, 183 days in any twelve month period

133. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 9.

134. Chile-U.S. Tax Treaty, *supra* note 36, art. 7.

135. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 2.

136. *See* U.N. DEP'T OF INT'L & SOC. AFFAIRS, *supra* note 127, art 5, ¶ 3(a), at 10.

137. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 3.

and such services are performed in and provided by individuals present in the source country.¹³⁸

Paragraph 4 of Article 5 moves forward on the term PE, excluding “ancillary” activities such as storage, display, maintenance of a stock of goods for processing purposes, and maintenance of a fixed place of business for auxiliary activities.¹³⁹ However, the Treaty does not contain a provision such as that included in both the 2006 U.S. Model and the 2010 OECD Model in which the maintenance of a fixed place of business solely for any combination of the aforesaid activities does not constitute a PE provided that the overall activity of the fixed place of business resulting from this combination is of a preparatory or auxiliary character.¹⁴⁰

The concept of electronic commerce brings new challenges to the definition of permanent establishment since the location of a website or computer equipment can constitute a PE with all of the consequences stemming from this qualification.¹⁴¹ The U.S. Technical Explanations make no comment on this issue, but the Commentaries have addressed this point by basically determining that the website hosting arrangement and an internet service provider usually will not be a PE.¹⁴² The issue of whether computer equipment at a given location constitutes a permanent establishment (under the concept of a fixed place of business) will depend on whether the functions performed using that equipment exceed the preparatory or auxiliary threshold, something that can only be decided with a case-by-case analysis.¹⁴³

The Treaty provides that certain activities are deemed to create a PE, regardless of whether the non-resident maintains a fixed place of business in the host country.¹⁴⁴ Specifically, a person (other than an independent agent) acting in the source country as an agent (“agency permanent establishment”) of an enterprise of the residency country who has the authority to conclude contracts that are binding on the enterprise will create a PE in the source

138. *Id.* In this respect, in the Commentaries, Chile expressly reserved the right to deem an enterprise to have a permanent establishment in certain circumstances where services are provided. See OECD CENTRE FOR TAX POLICY AND ADMINISTRATION [OECD TPA], THE 2010 OECD MODEL TAX CONVENTION (2010), cmt. 48 on art. 5, http://www.oecd-ilibrary.org/taxation/model-tax-convention-on-income-and-on-capital-condensed-version-2010_mtc_cond-2010-en.

139. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 4.

140. See TITLE & AVI-YONAH, *supra* note 121, at 47.

141. OECD COMM. ON FISCAL AFFAIRS, CLARIFICATION ON THE APPLICATION OF THE PERMANENT ESTABLISHMENT DEFINITION IN E-COMMERCE: CHANGES TO THE COMMENTARY ON ARTICLE 5 (2000), <http://www.oecd.org/dataoecd/46/32/1923380.pdf>.

142. *Id.*

143. OECD TPA, *supra* note 138, cmt. 42.8 on art. 5

144. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 5.

country unless the activities are limited to those mentioned in paragraph 4 (“ancillary activities”).¹⁴⁵

In this respect, the Commentaries on Article 5 provide that the mere fact that a person has attended negotiations with a client on behalf of the enterprise will not be sufficient in itself to conclude that that person has the ability to exercise authority to conclude contracts in the name of that enterprise.¹⁴⁶ However, the SII has expressly addressed this issue in Chile, ruling that if the agent carries out most of the negotiations of the agreement, fixing terms and resolving issues in connection with it, but he does not formally sign the agreement, such agent will be considered to have the authority to conclude contracts.¹⁴⁷

On the other hand, a foreign corporation shall not be deemed to have a permanent establishment if it conducts business in the country through an independent agent, broker, or general commission agent, and that agent or broker acts in the ordinary course of its business.¹⁴⁸

Finally, a company will not be deemed to have a permanent establishment in Chile or the United States merely because it has a subsidiary in Chile or the United States.¹⁴⁹ Thus, ownership or control between two companies is not a factor to determine the existence of a PE.¹⁵⁰

However, the Commentaries rule that if the subsidiary has any place or premises at the disposal of the parent company which constitutes a fixed place through which the parent conducts its business, it will constitute a PE for the parent company.¹⁵¹

The same conclusion is reached if the subsidiary has, and habitually exercises in that state, authority to conclude contracts in the name of the parent unless these activities are those considered of auxiliary or preparatory character or unless the subsidiary acts within its ordinary course of business as an independent agent.¹⁵²

145. *Id.*

146. OECD TPA, *supra* note 138, cmt. 33 on art. 5.

147. S.I.I., Oficio No. 2176, April 26, 2009 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2009/otras/ja2176.htm>.

148. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 6.

149. Chile-U.S. Tax Treaty, *supra* note 36, art. 5, ¶ 7.

150. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 120, art. 5, ¶

7.

151. OECD TPA, *supra* note 138, cmt. 40 on art. 5.

152. In the case of a company that is a member of a multinational group, the determination of the existence of a PE must be made separately for each member of the group. OECD TPA, *supra* note 144, cmt. 41 on art. 5.

3.2 *Income Attributable to a Permanent Establishment*

Under Article 7 of the Treaty, if a resident of a country carries out business in the source country through a permanent establishment, the source country will impose a tax at the regular rates¹⁵³ on the business profits, but only on those profits that are attributable to the permanent establishment.¹⁵⁴

The tax is applied on a net basis allowing deductions of expenses necessary for the business of the PE, including reasonable allocation of executive and general administrative expenses, research and development expenses, and interest, among others.¹⁵⁵ In order to determine the profits allocable to the PE, the same accounting method must be used each year.¹⁵⁶

The amount of profits attributable to the PE is a matter of much debate due to the complexity of applying this theoretical principle to a practical business reality.¹⁵⁷ The Treaty defines profits attributable to the permanent establishment as those it might be expected to make if it were a distinct and independent enterprise at arm's length¹⁵⁸ dealing with third parties and the enterprise of which it is a permanent establishment.¹⁵⁹

In this respect, it is important to bear in mind that a new Article 7 was added to the OECD Model on July 22, 2010, based on the conclusions derived from the 2010 OECD Report on the Attribution of Profits to Permanent Establishments.¹⁶⁰ This report takes into consideration functions performed, assets used, and risks assumed by the enterprise through the permanent establishment and through the other parts of the enterprise in order to determine the profit allocable to the enterprise and the PE.

The new addition is based on the fictional notion that the permanent establishment is a separate enterprise independent from the rest of the enterprise.¹⁶¹ Consequently, since the PE's result is independent from that of

153. Special rules are applicable to premiums and policies of reinsurance and insurance businesses, but limited to 2 percent and 4 percent respectively. *See* Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 8.

154. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 1.

155. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 3.

156. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 5.

157. *See* OECD TPA, REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2006), <http://www.oecd.org/dataoecd/55/14/37861293.pdf>.

158. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 120, art. 7, ¶ 3.

159. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 2.

160. *See* OECD TPA, 2010 REPORT ON THE ATTRIBUTION OF PROFITS TO PERMANENT ESTABLISHMENTS (2010), <http://www.oecd.org/dataoecd/23/41/45689524.pdf>.

161. OECD TPA, *supra* note 138, cmt. 16 on art. 7.

the enterprise, it may derive a profit (or loss) even if the enterprise of which it is a part has a loss (or a gain) based on a two-step analysis.¹⁶²

The first step involves a functional and factual analysis in order to determine the attribution of profits to the PE based on the following factors: the rights and obligations derived from the enterprise's transactions with unrelated companies; the identification of people functions and attribution of assets; the identification of people functions and risks involved; the identification of other functions of the PE; the nature of dealings between the PE and the enterprise; and the attribution of capital considering assets and risks.¹⁶³

The second step applies the OECD Transfer Pricing Guidelines ("the Guidelines") to transactions between the PE and its enterprise using the method established in the Guidelines to reach the arm's length price, giving special consideration to the functions performed and risks and assets attributed by the PE.¹⁶⁴

However, the most relevant and practical effect of the new Article 7 stems from its third paragraph, which rules that if the Contracting State adjusts the profits attributable to the PE — as a result of dealings using the separate entity assumption — and tax profits that are taxed at the enterprise level are located in the other state, the latter *must* adjust the tax charged on such profits in order to eliminate double taxation.¹⁶⁵ This amendment is an important advance in tax treaties since it obligates states to apply adjustments to avoid double taxation unlike the former Article 7, which contained no such provision.

Nevertheless, it is important to bear in mind that Chile presented reservations on these amendments.¹⁶⁶ Specifically, Chile did not endorse changes to the Article 7; hence the attribution of profits to a permanent establishment under Chilean tax policy is still acceptable on the basis of an apportionment of the total profits of the enterprise to its various parts.¹⁶⁷

The U.S. Federal Court of Appeals has provided that the treaty provision on PE deductions shall be interpreted to have primacy over the U.S. domestic rules related to allocation of expenses (i.e., royalties and interest),¹⁶⁸ which generally adopt a formulary approach and do not treat the

162. OECD TPA, *supra* note 138, cmt. 17 on art. 7.

163. OECD TPA, *supra* note 138, cmt. 21 on art. 7.

164. OECD TPA, *supra* note 138, cmt. 22 on art. 22.

165. OECD, *supra* note 10, art. 7, ¶ 7.

166. OECD TPA, *supra* note 138, cmt. 96 on art. 7.

167. *Id.*

168. See *National Westminster Bank, PLC v. U.S.*, 512 F.3d 1347 (Fed. Cir. 2008), motion for rehearing and motion for rehearing en banc denied, No. 2007-5028 (Fed. Cir. Apr. 21, 2008), for a recent decision confirming the supremacy of the U.K.-U.S. Tax Treaty's separate entity approach of a foreign bank (U.K.) and a

PE as a separate and distinct entity.¹⁶⁹ The court's decision ruled that the denial of the deduction of expenses, such as royalties, interest, and other expenses related to ancillary services performed for another unit of the enterprise, charged to a permanent establishment by another unit of the enterprise, violates the treaty provision on this matter.¹⁷⁰

The concept of "attributable" profits also includes payments deferred until the PE has ceased to exist.¹⁷¹ This provision grants the host state tax authority on income attributable to the permanent establishment even if the payments are deferred until such permanent establishment or fixed base has ceased to exist.¹⁷² An example of income attributable to a PE that ceases to exist is the sale of its inventory of assets after its liquidation under an installment method that bears interest. The interest generated in subsequent years will also be considered effectively connected and therefore taxed in the host country. This provision is similar, but not identical, to that included under section 864(c)(6) of the I.R.C., but without the limitation of years included in section 864(c)(7).

These provisions consider the sale of a PE made within ten years after the cessation of use of property held in the United States as made immediately before such cessation.

Paragraph 4 of Article 4, in conjunction with Article 5(4)(d), provides that business profits are not attributed to a permanent establishment by reason of mere purchases of goods.¹⁷³ This provision aims to overrule section 864(c)(3) of the IRC, which includes the limited force of attraction rule by which all income accrued by a foreign company is treated as effectively connected with the conduct of a trade or business within the United States.

Finally, paragraph 7 of Article 7 states that if profits include items of income dealt with separately in other articles, the specific provisions included thereby will prevail over this Article.

4. *Taxation of Dividends in the Treaty*

The Treaty grants unlimited tax authority to the country of which the recipient of the dividend is a resident. However, limited tax authority is also granted to the source country (the country of which the distributing company

branch under the U.S. domestic rules. *See also* William W. Chip, *Interpreting Tax Treaties After NatWest*, 37 TAX MGM'T INT'L J. 1, 2 (2008).

169. In *National Westminster Bank v. U.S.*, 44 Fed. Cl. 129 (Fed. Cl. 1999) the court held that the U.S. branch of a U.K. Bank was a separate entity under the U.S.-U.K. treaty.

170. *See Westminster Bank*, 512 F.3d. at 1347.

171. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 7.

172. *Id.*

173. Chile-U.S. Tax Treaty, *supra* note 36, art. 7, ¶ 4; art. 5, ¶ 4(d).

is a resident).¹⁷⁴ In this case, the withholding tax shall not exceed 5 percent of the gross amount of the dividends if the non-resident shareholder owns at least 10 percent¹⁷⁵ of the capital company and 15 percent of the gross amounts of the dividend for all other cases.¹⁷⁶ As mentioned above — and in line with the reservations presented by Chile to the OECD — these reductions on tax rates are not applicable to Chile as long as the First Category Tax is creditable against the Additional Tax.¹⁷⁷

Paragraph 14 of the Treaty Protocol provides different rules for dividends arising from the ownership of stocks in a Regulated Investment Company (RIC) or in a Real Estate Investment Trust (REIT) incorporated in the United States.¹⁷⁸ In the first case, this provision is aimed at denying the reduced tax rate of 5 percent to dividends in connection with U.S. stocks in RICs applying the regular rate of 15 percent regardless of the ownership percentage.¹⁷⁹ This provision seeks to avoid a tax benefit being obtained through the incorporation of a holding company. Indeed, in the absence of this provision, if a Chilean resident owns the portfolio of stocks directly, the dividends will be taxed at 15 percent, but if the stocks are owned by a RIC wholly owned by a Chilean resident, he will be entitled to the 5 percent reduced tax rate.¹⁸⁰

The second part of this provision is related to a U.S. tax policy in which it usually reserves the right to tax all income derived from real estate located in the United States.¹⁸¹ In accordance with the Protocol, the reduced tax rate of 15 percent (instead of the domestic 30 percent rate) is only granted if: (i) the beneficial owner of the dividends is an individual holding an interest of 10 percent or less; (ii) the dividends are paid with respect to publicly traded stocks and are beneficially owned by a person who holds no more than 5 percent in any class of REITs; or (iii) the dividends are paid by a diversified REIT and are beneficially owned by a person holding a 10 percent or smaller interest in the REIT.¹⁸²

174. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 1.

175. The U.S. Model requires direct ownership of at least 10 percent of the voting stock of the company paying dividends, whereas the OECD Model requires ownership of at least 25 percent of the company's capital to be eligible for the reduced tax rate of 5 percent.

176. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 2(a)–(b).

177. *See infra* section II.2, OECD TPA, *supra* note 138, cmt. 74 on art. 10.

178. Chile-U.S. Tax Treaty, *supra* note 36, Protocol, ¶ 14.

179. *Id.*

180. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 10, ¶ 4. However, neither the Treaty nor its technical explanations specify if constructive or indirect ownership applies to determine the “real” participation in the company.

181. I.R.C. § 897.

182. Requirements on (i) and (ii) are new additions of the 2006 U.S. Model not included in the 1996 U.S. Model. *See* STAFF OF J. COMM. ON TAXATION,

The term “dividends” is defined broadly and includes “income from shares or other rights not being debt-claims, participating in profits,” and any other form of distribution that is defined as a dividend under the laws of the distributing company.¹⁸³ For example, in accordance with Article 21 of the CITL, a loan from a Chilean subsidiary to its parent incorporated in the United States may be considered a dividend for purposes of applying this Article.¹⁸⁴ On the other hand, the sale or redemption of shares or upon a transfer of shares in reorganization, such as the sale of a foreign subsidiary’s stock to a U.S. sister company, is a deemed dividend up to the accumulated earnings and profits of the subsidiary and the sister company.¹⁸⁵

Nevertheless, it is unclear whether the term “dividends” applies to payments based on the profits of a company but paid in accordance with a lending stock arrangement under the term “substitute dividends.” The relevance of this matter is that if Article 10 is not applicable, the residual provision established under Article 7 of the Treaty will apply. In consequence, substitute dividends will be considered business profits and only taxable by the country of residency of the beneficial owner of the income (the United States in this case).

Regarding this matter, the Commentaries point out that the term “profits” “has a broad meaning including *all income* derived from carrying on an enterprise.”¹⁸⁶ In consequence, any income derived from the regular trade or business of financial or investment companies should be considered business profits and thus exempt from withholding taxes in Chile.

Authors like Marjaana Helminen agree on this concept, stating: “The recipient of substitute dividend payments is not, strictly speaking, a shareholder and the substitute payments do not derive from corporate rights, but, instead, are based on a lending contract.”¹⁸⁷

An exemption from the source country is provided for dividends paid to certain pension funds.¹⁸⁸ In this case, no tax is imposed on the dividends by the distributing company as long as they are not derived from commercial

COMPARISON OF THE U.S. MODEL INCOME TAX CONVENTION OF SEPTEMBER 20, 1996 WITH THE U.S. MODEL INCOME TAX CONVENTION OF NOVEMBER 15, 2006 11 (Comm. Print, 2007).

183. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 4.

184. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 5; *see also* OECD TPA, *supra* note 138, cmt. 25 on art. 10, ¶ 3.

185. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 10, ¶ 5.

186. OECD COMM. ON FISCAL AFFAIRS, MODEL TAX CONVENTION ON INCOME AND ON CAPITAL: CONDENSED VERSION (8th ed. 2010), cmt. 71 on art. 7 (emphasis added).

187. MARJAANA HELMINEN, THE DIVIDEND CONCEPT IN INTERNATIONAL TAX LAW: DIVIDEND PAYMENTS BETWEEN CORPORATE ENTITIES 176 (1999).

188. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 3; U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art.10, ¶ 3.

activities performed directly or from a company controlled by the qualified governmental entity.¹⁸⁹

However, dividends will be taxable under Article 7 as a part of the business profits of a PE — therefore fully taxable at source — if they are paid with respect to holdings forming part of the assets of the permanent establishment or the dividends are attributable to that PE.¹⁹⁰

Paragraph 6 of Article 7 provides that if a distributing company that is located in a contracting state (i.e., Chile) obtains income in the other contracting state (i.e. the United States), the latter cannot tax the distributions made by the company in Chile unless these distributions are paid to residents of the United States or to a permanent establishment of the Chilean company in the United States that holds stock of the distributing company. In addition, the I.R.S. cannot tax the undistributed profits of the Chilean company even if those profits consist of income obtained in the United States.

To understand this provision, it is important to bear in mind that the United States formerly imposed a “secondary withholding tax” on dividends or other distributions paid by a non-resident foreign corporation to non-residents, if most of the income came from the United States.¹⁹¹ Indeed, the I.R.C. provided authority to the United States to tax dividends paid by a non-resident corporation if 25 percent or more of its gross income that was effectively connected with trade or business in the United States¹⁹²

Paragraph 6 of Article 7 does not preclude the right of the United States to tax undistributed profits under controlled foreign corporation provisions¹⁹³ aimed at avoiding tax deferral by establishing subsidiaries in low tax countries without truly conducting a trade or business there.¹⁹⁴

Finally, it is important to bear in mind that the Treaty does not incorporate an additional clause regularly included in most Chilean tax treaties to limit the benefit of this Article to stocks acquired with a legitimate business reason.¹⁹⁵ This paragraph provides that the benefit of this Article

189. *Id.*

190. Chile-U.S. Tax Treaty, *supra* note 36, art. 10, ¶ 5; *see also* OECD TPA, *supra* note 138, cmt. 31 on art. 10.

191. This secondary tax was repealed for payments made after December 31, 2004 in the American Jobs Creation Act of 2004. *See also* U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 10, ¶ 7.

192. I.R.C. §§ 861(a)(2)(B), 871(a)(1)(A), 881(a)(1).

193. *See also* U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 10, ¶ 7.

194. *See* I.R.C. § 951.

195. This clause is also included with respect to interest, capital gains, royalties, and other income. *See*, for instance, Article 10(6) of the Chile-U.K. Tax Treaty: “The provisions of this Article shall not apply if it was the main purpose or one of the main purposes of any person concerned with the creation or assignment of the shares or other rights in respect of which the dividend is paid to take advantage of this Article by means of that creation or assignment.” Convention Between the

shall not apply if the main purpose or one of the main purposes of any person is to take advantage of this Article by creating or assigning the shares or other rights in respect of which the dividend is paid.¹⁹⁶ This provision was omitted mainly because of the extensive scope of Article 24 (Limitation on Benefits) that covers this situation to a greater extent.¹⁹⁷

5. *Taxation of Interest in the Treaty*

Under Article 11 of the Treaty, full tax jurisdiction is granted to the country in which the recipient of the interest is a resident, and limited tax jurisdiction is granted to the country in which the payer of the interest is domiciled.¹⁹⁸ The latter country can impose a withholding tax on such interest that shall not exceed 10 percent of the gross amount of the interest. However, this tax rate is raised to 15 percent during the first five years the Treaty is in force.¹⁹⁹ From a practical standpoint, the burden of this tax is usually transferred to the borrower, which translates into a higher interest rate for the transaction, a result that can be undesirable, especially for residents of developing countries (e.g., Chile) seeking funds to finance projects.²⁰⁰

The term “beneficial owner” is not defined in the Treaty; hence, it must be defined in accordance with the domestic law of the source country. For this purpose, the source country is that in which the resident to whom the contracting state of residency attributes the payment for tax purposes.²⁰¹

Article 11(2)(a) provides that the tax rate on interest derived from the following activities shall not exceed 4 percent (instead of the regular 10 percent): (A) loans granted by banks, insurance companies, and companies that derive their gross income from the active and regular conduct of lending money; (B) a sale or credit paid by the purchaser of machinery and equipment to a beneficial owner that is the seller of the machinery and equipment; and (C) interest arising from enterprises that derive more than 50 percent of their liabilities from issuing bonds in the financial market and

Government of the United Kingdom of Great Britain and Northern Ireland 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 and on Capital Gains, U.K.-Chile, July 12, 2003, art. 10, ¶ 6, http://www.sii.cl/pagina/jurisprudencia/convenios/chile_reinounido_english.pdf.

196. This clause follows the advice of the Commentary on Article 10, ¶¶ 2 and 32. OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmts. 2 & 32 on art. 10.

197. *See infra* section V.

198. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 1.

199. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶¶ 2, 3.

200. OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmt. 7.1 on art. 11.

201. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 11,

¶ 1.

taking deposits at interest as long as more than 50 percent of their assets are based on non-debt claims with unrelated persons as defined in article 9 of the Treaty.²⁰²

This Article has a major difference with the 2006 U.S. Model since Article 11 of the model grants the exclusive right of taxing interest only to the state of which the beneficial owner of the interest is a resident, and therefore no withholding tax is applied by the source country.²⁰³ These changes to the tax rates are within the flexibility granted under the U.N. Model and the OECD Commentaries on this Article.²⁰⁴

The reduced tax rates are established only for the beneficial owner of the interest, which—as with the corresponding provision with respect to dividends—must be interpreted broadly while still taking into consideration that the Treaty is designed to avoid double taxation and tax avoidance.²⁰⁵ For example, if a third party that is a resident from a country without a tax treaty with Chile establishes a corporation in a country with a tax treaty to access the 10 percent tax rate instead the 35 percent tax rate, this corporation will be the recipient of the interest, but the real beneficial owner is the resident of the third party country; thus, the reduced rate shall be denied by Chile.²⁰⁶

On the other hand, the Treaty includes an express provision for back-to-back loans granting a 10 percent tax rate to interest arising from this type of transaction.²⁰⁷ In the case of Chile, this provision will conflict with the SII position on the matter expressed in Revenue Ruling 3939 of 2004 (“R.R. 3939”).²⁰⁸ In this ruling, the SII decreed that the rate reduction from 35 percent to 15 percent in accordance with Article 11 of the Chile-Canada Tax Treaty is not applicable on interest paid to a Canadian beneficial owner because of thin capitalization rules.²⁰⁹

This conclusion was based on a formality established in the CITL under which the interest paid by the payor on a back-to-back arrangement is deductible from its gross income; hence, the SII claimed that this “special” tax burdened the payor (Chilean resident) and not the recipient (Canadian

202. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 2(a)(v).

203. *See* TITLE & AVI-YONAH, *supra* note 120, at 93.

204. OECD TPA, *supra* note 138, cmt. 7.2 on art. 11. It is interesting to note that all those considered “not as much” developed countries of the OECD such as Chile, Hungary, Mexico, Portugal, the Slovak Republic and Turkey presented reservations of their positions on the rate provided in paragraph 2. OECD TPA, *supra* note 138, cmt. 38 on art. 11.

205. OECD TPA, *supra* note 138, cmt. 9 on art. 11.

206. In this case, the provisions of Article 24 (Limitation on Benefits) will also be applicable. Chile-U.S. Tax Treaty, *supra* note 36, art. 24.

207. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 4.

208. S.I.I., Oficio No. 3939, Aug. 19, 2004 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2004/otras/ja813.htm>.

209. *Id.*

resident) and thus was not eligible for the benefits of the Chile-Canada Tax Treaty.²¹⁰ However, R.R. 3939 shall not be applicable in cases of interest payments to a U.S. resident, since the Treaty has supremacy over domestic law and certainly over an administrative ruling; therefore, in this case the 10 percent rate shall be applicable.

Another consideration to bear in mind is that in accordance with Article 11(3) of the Treaty, for a period of five years from the date on which the provisions of paragraph 2 take effect, the 15 percent rate “shall apply in place of the rate provided in subparagraph b) of paragraph 2.”²¹¹ Since the back-to-back provisions are enacted in a separate paragraph (paragraph 3 of Article 11), there is no certainty that the rate increase from 10 to 15 percent is applicable to this type of transaction because they are not included in subparagraph b) of paragraph 2.

The term “interest” is used to comprise “income from debt-claims of every kind” including mortgages and all other income that is subjected to the same taxation treatment as income from money lent under the laws of the country where the payor is a resident.²¹² The term does not include disguised dividends, which shall be treated as described under Article 10 of the Treaty.²¹³ This last point is relevant because interest is subject to different rates (4 percent, 10 percent, and 15 percent) under domestic and treaty provisions, and these rates differ from those applicable to dividends (5 percent or 15 percent in the United States and 35 percent in Chile). Furthermore, it is important to bear in mind that interest is tax deductible, whereas dividends are not deductible from the taxpayer’s gross income.

Article 7 — instead of Article 11 — applies if the beneficial owner of the interest has a PE in the source country, but only if the interest income is attributable to this PE.²¹⁴ Therefore, in this case the Treaty grants full tax authority to the source country.²¹⁵

As mentioned above, interest is sourced in the country in which the payor is a resident (e.g., Chile); however if the loan has an obvious link with a PE in a contracting state (e.g., the United States) and the interest is borne by that PE, the source rule is modified, and the place where the PE is located determines the source (e.g., the United States).²¹⁶

The Treaty also provides a special rule for interest derived from a debt-claim between related parties in which one related party charges excessive interest to the other related party to access the reduced tax rates of

210. *Id.*

211. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 3.

212. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶¶ 5, 7.

213. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 5.

214. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 6.

215. OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmt. 27 on art. 11.

216. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 7.

this Article.²¹⁷ Only the part of the interest that is based on arm's length price can access the reduced tax rate in this Article, whereas the remaining portion will receive the general tax treatment of each country but respecting the other provisions of the Treaty.²¹⁸ For instance, if the excessive part is considered a dividend, the tax law of each country will apply, but with the limit on the applicable tax rates under Article 10 of the Treaty.²¹⁹

Article 11(9) of the Treaty grants the tax rate of 15 percent applicable to dividends to contingent interest connected to receipts, sales, income, profits, dividends, partnership distributions, or other cash flows and changes in the value of the property of the debtor or a related person.²²⁰ However, if the interest is paid as a consequence of a securitization plan of real estate mortgages or other assets,²²¹ and the interest is greater than the return of a similar debt instrument, full tax authority is granted to the source country without the 15 percent limitation.²²²

Finally, paragraph 10 of Article 11 includes a special provision for interest (i) allocable to profits attributable to a PE under the provisions of the Treaty or (ii) subject to tax under the provisions on real estate income or capital gains.²²³ In these cases, if there is excess interest allocable to such profits or income that exceeds the interest effectively paid, it will be deemed to arise in the source country and be taxable with the 10 percent tax rate (or 15 percent for the first five years that the Treaty is in force).²²⁴

6. *Taxation of Royalties in the Treaty*

Unlike the U.S. and OECD Models, which grant an exclusive right of taxation to the country of residency of the beneficial owner of the royalty, the Treaty also permits taxation by the source country.²²⁵ However, in this

217. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 8.

218. *Id.*

219. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 11, ¶ 5.

220. Chile-U.S. Tax Treaty, *supra* note 36, art.11, ¶ 9(a). *See also* U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 11, ¶ 2.

221. This provision has no parallel rule in the OECD Model or its Commentaries.

222. In this case, there is no special provision to grant a different tax treatment for interest not paid in excess of the return on comparable debt instruments and interest that exceeds such return. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 9(b).

223. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 10.

224. *Id.*

225. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶ 2. This is consistent with the reservation presented by Chile to the Commentaries in which it reserves the

case there is a maximum withholding tax rate limit of 2 percent in the case of payments of any kind received as a consideration for the use of, or the right to use, industrial, commercial, or scientific equipment and 10 percent for other types of royalties.²²⁶

It is important to bear in mind that payment for the use of equipment generally falls under Article 7 of the OECD and U.S. Models, thus it is not taxable at source.²²⁷ However, this clause is usually included by developing countries following the 2001 U.N. Model, since it is likely that most payments of this type will be received by U.S. residents, and therefore the source country will get a “fair cut” on these payments.²²⁸

The term “royalties” includes any “consideration for the use of, or the right to use, any copyright of literary, artistic [or scientific work]” including films, any patent, trademark, design or model, plan, secret formula or process, or “information concerning industrial, commercial or scientific experience.”²²⁹ Another important distinction is between a know-how contract and a contract for the provision of services. The former must be understood only as sharing of private and specific knowledge but it does not obligate the licensor to play a part in the application of the formula transferred to the licensee, whereas the latter includes work completed by the other party and, therefore, is taxable under Article 7.²³⁰

In this respect, the Protocol of the Treaty includes a direct reference to the Commentary to Article 12 of the OECD Model for an analysis of taxation applicable to computer software.²³¹ For instance, the commentary on this Article points out that transfers of software will not always be considered use of intellectual property.²³² Indeed, if the software is completely transferred, this is not considered payment for use of intellectual

right to tax royalties at their source. *See also* OECD TPA, *supra* note 138, cmt. 36 on art. 12.

226. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶¶ 2, 3.

227. For a more extensive analysis on this matter, see U.N. DEP'T OF INT'L & SOC. AFFAIRS, *supra* note 127, at 127.

228. See also Article 12 of the U.S.-Mexico Treaty for a more generous 10 percent concession from the United States to Mexico. U.S.-Mex. Tax Treaty, *supra* note 126, art. 12.

229. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶ 3(b). See also OECD TPA, *supra* note 138, cmt. 40 on art. 12, in which Chile reserves the right to add the words “for the use of, or the right to use, industrial, commercial or scientific equipment” to paragraph 2 of the OECD Model.

230. OECD TPA, *supra* note 138, cmts. 11.3–4 on art. 12, provides several criteria that must be used to distinguish between a contract for provision of services and a know-how contract.

231. *See* Chile-U.S. Tax Treaty, *supra* note 36, Protocol, ¶ 15.

232. OECD TPA, *supra* note 138, cmt. 11.5 on art. 12.

property but rather payment for the full property of the assets. In this case, Article 7 (business income) or Article 13 (capital gain) will apply.²³³

However, it is important to consider that gain derived from the sale of intellectual property is treated as a royalty if it is recognized on receipt of a payment “contingent on the productivity, use, or disposition of the property.”²³⁴ This provision is consistent with U.S. regulations that mandate that contingent payments for the U.S. owner of the intellectual property must be calculated with due regard to the appropriate charge determined in accordance with section 482 and the regulations thereunder.²³⁵

As mentioned above, the term “beneficial owner”²³⁶ is not defined in the Treaty; however, the OECD commentaries on Article 10 on dividends are also applicable in this case and make clear that this term must be interpreted “in its context and in light of the object and purposes of the Convention, including avoiding double taxation and preventing fiscal evasion and avoidance.”²³⁷

Notwithstanding the limited right of taxation granted to the source country (i.e., Chile), if the beneficial owner of the royalty conducts business in the other contracting state (i.e., the United States) through a permanent establishment and the right of property with respect to which the royalties if paid are effectively connected with this PE, the provisions of Article 7 will apply, and therefore such royalties will be taxed under the general tax rates of the United States.²³⁸

As with interest, the Treaty provides that if prices charged in royalties between parties with a special relationship²³⁹ are not based on an

233. OECD TPA, *supra* note 138, cmt. 8.2 on art. 12.

234. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶ 3(b).

235. I.R.C. § 482 provides that “[i]n the case of any transfer (or license) of intangible property . . . , the income with respect to such transfer or license shall be commensurate with the income attributable to the intangible.” *See also* Reg. § 1.367(d)-1T(c)(1).

236. This is a topic of much controversy. For instance, in the Canadian *Prevost Car Inc.* case, two E.U. members established a subsidiary in a third E.U. member to invest in a non-E.U. member (a Swedish company and a British company established a subsidiary in the Netherlands that later invested in Canada). The court examined the meaning of “beneficial owner” under the Canada-Netherlands Tax Treaty. The Tax Court of Canada ruled that if the beneficial owner of a dividend is the person who assumes and enjoys all of the attributes of ownership of that dividend, including control of the dividend received, tax benefits can be granted to the holding company in the Netherlands. *Prevost Car Inc. v. Canada*, [2008] 2008 CarswellNat 1114, 2008 TCC 231 (Can.).

237. OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmt. 12 on art. 10, is also applicable to interest and dividends.

238. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶ 4.

239. According to the OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmt. 24 on art. 12, the term “special relationship” includes relationships based on

arm's length price, the excess can be taxable under the laws of the contracting states with due regard to other articles of the Treaty.²⁴⁰

A current controversy related to this topic is cost sharing agreements ("CSAs"). These agreements consist of a contract signed by two or more parties to participate in the costs and risks related to the development, production, and procurement of assets, services, or rights, intended to determine each party's share of the assets, services, or rights arising from that agreement.²⁴¹

CSAs have the benefit that once the objective for which the agreement was signed is achieved, each of the participants is considered to own his share, and, therefore, no royalty payment or other amount must be paid to use that share. This can encourage the creation of intellectual property in different countries and the use of new technologies since CSAs are usually used to develop intellectual property among multinational enterprises.²⁴²

Nevertheless, the conflict arises due to the use (or abuse) of CSAs to shift profits to related companies incorporated in countries with lower tax burdens.²⁴³ This might be an issue in the Chile-U.S. Tax Treaty due to the disparity of the current corporate tax rates (35 percent for the United States and 20 percent for Chile).²⁴⁴

For instance, in *Xilinx v. Commissioner*, the U.S. Court of Appeals (Ninth Circuit) established that in case of conflict between the application of transfer pricing rules and the contents of the tax treaty, the former takes precedence over the latter regarding citizens of each country.²⁴⁵ In particular, the U.S. Court of Appeals held that related companies established in the United States and Ireland (that has a corporate tax rate of 12.5 percent) in a cost sharing agreement to develop intangibles must share all costs related to the joint venture even if unrelated companies would not do so, therefore denying the fiction of fully independent parties. This is based on the fourth paragraph of the first article of the Ireland-U.S. Tax Treaty, which

"blood or marriage and, in general, any community of interests as distinct from the legal relationship giving rise to the payment of the royalty."

240. Chile-U.S. Tax Treaty, *supra* note 36, art. 12, ¶ 6.

241. OECD, TRANSFER PRICING GUIDELINES FOR MULTINATIONAL ENTERPRISES AND TAX ADMINISTRATIONS, ¶ 8.3 (2010).

242. *Id.* ¶ 8.6.

243. Yariv Brauner, *Cost Sharing and the Acrobatics of Arm's Length Taxation*, 38 INTERTAX 554 (2010).

244. This problem can acquire greater relevance when Chile's corporate tax rate returns to the former 17 percent in 2013 in accordance with Law No. 20.455 (2010).

245. *Xilinx v. Commissioner*, 567 F.3d 482, 494 (9th Cir. 2009).

establishes that each country may tax its citizens as if the treaty had never taken force.²⁴⁶

7. *Capital Gains in the Chile-U.S. Tax Treaty*

This section will review the main tax provisions in connection with capital gains on both traditional assets and non-traditional assets (i.e. financial instruments).

7.1 *Capital Gains on Traditional Assets*

The Treaty provides, as a general rule, that both the country of which the alienator is a resident and the source country can tax the capital gain.²⁴⁷ The term “capital gain” is not defined in the Treaty, so its scope must be framed within the laws of the country for the purposes of the taxes to which the Convention applies.²⁴⁸ For instance, liquidation or a reduction of the paid-in capital of a U.S. corporation in which the shareholder sells its shares to the issuing company may be treated as a dividend under Article 10 of the Treaty rather than capital gain under Article 13.²⁴⁹ In this case, the provisions of Article 10 will prevail over this article and, therefore, the tax treatment granted for dividends shall be applied.²⁵⁰

In accordance with Article 13 and following the same principle as the OECD Model, the Treaty gives the right to tax income to the country in which the real property is situated. However, the Treaty includes an explicit definition of the term “real property,” applying the concept of U.S. real property interest as defined in section 897 of the I.R.C. and the regulations thereunder.²⁵¹

The definition contained in this article creates an important difference with the OECD Model. Under the terms of this Article of the Treaty, there is not a 50 percent ownership threshold requirement as in the

246. Convention Between the Government of the United States of America and the Government of Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital Gains, U.S.- Ir., July 28, 1997, art 1, ¶ 4. This provision is based on a principle known as the “savings clause,” by which the United States never waives its tax authority over its citizens regardless of how much time they have resided abroad.

247. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 1. See also OECD TPA, *supra* note 138, cmt. 39 on art. 13 for an explicit reservation that Chile presented to the Commentaries on Article 13 enabling capital gains to be taxed at source.

248. Chile-U.S. Tax Treaty, *supra* note 36, art. 3, ¶ 2.

249. OECD TPA, *supra* note 138, cmt. 31 on art. 13.

250. *Id.*

251. See Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 2.

OECD Model to trigger the full tax at source, and, therefore, any sale of shares that meets the asset-ratio test for being U.S. property will be taxable in the United States.²⁵²

The gain derived from immovable property situated in Chile or from a sale of shares in which at least 50 percent of the value is derived from immovable property, may be taxable in Chile.²⁵³ In this respect, it is important to bear in mind that the gain can be exempt from taxes if the seller of the real estate property has held the Chilean real estate property for at least one year, the seller does not sell real estate property on a customary basis, and such sale is not made to a related party.²⁵⁴

In the case of a resident of a contracting state that has a PE in the other country and alienates movable property that forms part of the business property of the PE, the source country can tax the capital gain derived from the alienation of both the assets of the PE and the PE as a whole.²⁵⁵ This paragraph corresponds to the provision under Article 7 related to business profits.²⁵⁶ Similar treatment will be granted in the United States for a Chilean partner of a U.S. partnership, but in this case the United States has the authority to apply tax on the partner's distributive share of income under section 864(c)(6) of the I.R.C.²⁵⁷

The right to tax gains from the alienation of ships and aircrafts operated on international routes, boats engaged in waterway transport, or movable property related to the operation of those ships, aircrafts, and boats is granted only to the country of residency of the alienator.²⁵⁸ This provision is similar to that used by the OECD, but it has an important difference since the OECD uses the concept of "place of effective management" instead of "place of residency."²⁵⁹

Article 13(5) sets forth a general limit of 16 percent for capital gains arising from the alienation of other rights or interests on the capital of companies incorporated in the other country.²⁶⁰ However, this general rule has three main exceptions: (i) capital gains derived by a pension fund are

252. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 13, ¶ 2.

253. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 2(c).

254. L.I.R. art. 17, No. 8(b).

255. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 3.

256. OECD TPA, *supra* note 138, cmt. 24 on art. 13.

257. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 13,

¶ 3.

258. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 4.

259. OECD COMM. ON FISCAL AFFAIRS, *supra* note 186, cmt. 28 on art. 13.

260. As mentioned above, this limit is only relevant for Chilean tax purposes since the United States generally exempts capital gains if certain conditions are met. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 5. *See also* section II.5

only taxable at the state of residency;²⁶¹ (ii) capital gains derived from shares or rights in the capital of a company that is resident in the other state are taxable at source if the alienator has owned, at any time during the twelve-month period preceding the alienation, 50 percent or more of the *shares* or 20 percent or more of the *rights* of a company;²⁶² and (iii) capital gains derived from the sale of shares that meet the conditions set forth in Articles 106 and 107 of the CITL for publicly traded securities disposed on a recognized stock exchange are not taxable in Chile.²⁶³

Finally, a step-up basis is granted to an individual who ceases to be a resident of a country (e.g., the United States) and is taxed with “an exit or departure tax” on the fair market value of the property.²⁶⁴ In such case, the former resident may elect to be treated in the other country (e.g., Chile) as if he alienated and reacquired such property. However, this benefit is only granted to property located in the former country (e.g., the United States) and does not apply to property located in the other country (e.g., Chile).²⁶⁵

7.2 Capital Gains on Non-Traditional Assets

The use of financial instruments such as forwards, options, and equity swaps for both hedging and speculative investment presents important challenges for the application of Article 7 (business profits), Article 10 (dividends), Article 11 (interest), Article 13 (capital gains), and Article 21 (other income) under the Treaty because such instruments present a variety of components that make it difficult to determine their tax treatment *a priori*.²⁶⁶

The basic rule on financial instruments is that if they derive from the conduct of a trade or business they are considered business profits and taxable under Article 7 of the Treaty.²⁶⁷ If they are not connected to a trade

261. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 6(a).

262. However, the Protocol rules that the tax imposed by Chile under the provisions of paragraph 7 of Article 13 shall not exceed 35 percent. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 7(a)–(b).

263. This rule would also apply for the United States if a tax were imposed on capital gains in the future. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 6(b)–(c). *See also* section II.5.

264. This provision is currently applied only to U.S. residents, since Chile does not include a similar provision in the L.I.R. *See* I.R.C. § 877A(h)(2), enacted by Heroes Earnings Assistance and Relief Tax Act of 2008, Pub. L. No. 110-245, § 301(a), 122 Stat. 1624 (2008).

265. Chile-U.S. Tax Treaty, *supra* note 36, art. 13, ¶ 9.

266. *See generally* Reg. § 1.861-3(a)(6) for the concept of substitute dividends in securities lending transaction.

267. The Authority for Advance Rulings (AAR) of India, in the case of Royal Bank of Canada (A.A.R No. 816 of 2009), held that the profits/losses on

or business, to the extent that such income is not otherwise taxable under another article (e.g. Article 10 or Article 11), they can be taxable under Article 13.²⁶⁸ However, this income can also be included under other income in accordance with Article 21 of the Treaty.²⁶⁹

The difference is not minor, since under the Treaty income characterized as “business profits” is not taxable at source; income deemed capital gain is not taxable at source unless it represents interest rights or interest in the capital of a company; and income considered “other income” is fully taxable at source. Indeed, unlike the 2006 U.S. Model and the OECD Model, following the U.N. Model and the reservations presented by Chile to the Commentaries, Article 21 of the Treaty grants full tax authority to both the residence and the source country on income not specifically dealt with in another article of the Treaty.²⁷⁰

The two most relevant issues connected to the taxation of derivatives relate to the characterization of the income and the point in time when the income is taken into account for tax purposes.²⁷¹ On the first topic, “some [states] would treat the income from a derivative contract as a capital gain, whilst others would treat it as ordinary income.”²⁷² Regarding the second issue, some countries would take into account the income from a derivative contract on an accrual basis (i.e., over the lifetime of the instrument) and others on a realization basis (i.e., when it is actually paid).²⁷³

Due to the complexity and ongoing development of the financial market, there are many varieties of financial instruments. The next section describes the tax treatment under the Treaty of one of the most commonly used instruments: the equity swap.

7.2.1 *The Equity Swap: A Practical Approach*

Under the equity swap, the short party pays the long party

over the life of the swap, amounts equal to the excess, if any, of the dividends paid on a specified number of shares of the

futures and options contracts (derivative transactions) carried out by a Canadian entity would be considered “business income.”

268. See U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 13, ¶ 6.

269. See U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 21.

270. Chile-U.S. Tax Treaty, *supra* note 36, art. 21, ¶¶ 1–3. See also OECD TPA, *supra* note 138, cmt. on 13 art. 21.

271. CHRIS FINNERTY ET AL, FUNDAMENTALS OF INTERNATIONAL TAX PLANNING 164–170 (Raffaele Russo ed. 2007).

272. *Id.* at 165.

273. *Id.*

common stock of a specified corporation . . . that have a specified value on the date the swap is entered into (the “notional amount” of the swap) over the interest that would accrue at a specified interest rate on the notional amount of the swap; plus . . . at maturity of the swap, amounts equal to . . . any increase in the market value of the specified shares over the life of the swap.²⁷⁴ Likewise, the long party pays the short party an amount equal to any excess of interest accruing at the specified interest rate on the notional amount of the swap over the dividends paid on the specified shares, plus . . . at maturity of the swap, an amount equal to any increase in the market value of the specified shares over the life of the swap.²⁷⁵

This type of income shall be reviewed on a case-by-case basis; however, in the case of the equity swap explained above, if such instrument is entered into as part of the regular course of business, the income arising from this contract will be included in Article 7.²⁷⁶ However, if the equity swap contract is entered into as a result of a specific transaction, the income arising from this agreement is taxable under the general income tax law of the country where it arises under Article 21 of the Treaty.²⁷⁷

In the United States, the Treasury Regulations provide certain guidelines to address the taxation of international financial instruments using the concept of “notional principal contract.”²⁷⁸ For this purpose, “[a] notional principal contract is a financial instrument that provides for the payment of amounts by one party to another at specified intervals calculated by reference to a specified index upon a notional principal amount in exchange for specified consideration or a promise to pay similar amounts.”²⁷⁹ The income arising from this type of transaction is sourced by reference to the residence of the taxpayer on whose books the asset, liability, or item of income or expense is properly reflected.²⁸⁰ If the income is sourced in the U.S., the taxpayer may elect to treat the income arising from

274. David Hariton, *Equity Derivatives, Inbound Capital and Outbound Withholding Tax*, 60 TAX. LAW. 313, 321 (2007).

275. *Id.*

276. See, for instance, OECD TPA, *supra* note 138, cmt. 21.1 on art. 11, for express mention that the concept of interest is not applicable to non-traditional financial instruments such as interest swaps.

277. Chile-U.S. Tax Treaty, *supra* note 36, art. 21, ¶ 3.

278. Reg. § 1.863-7(a)(1).

279. *Id.*

280. Reg. § 1.863-7(b)(1).

notional contracts as ordinary income/loss in which case it will be treated as interest, or he may elect to treat it as capital gain/loss.²⁸¹

In Chile, the use of derivative instruments has been subject to specific SII revenue rulings but is not addressed in a systematic regulation with a more general scope.²⁸² Under these terms, the SII has determined that if funds are remitted abroad to meet the conditions of a derivative for hedging purposes, no withholding tax is applied.²⁸³ However, if such remittance has a speculative purpose, the transaction will be taxable in Chile with a 35 percent withholding rate.²⁸⁴

Since determining the hedging or speculative purpose of the derivative is a very subjective issue from a practical standpoint, the Chilean Congress just passed a bill to modify the law, introducing a special tax regime for derivative instruments.²⁸⁵ Under this law, derivatives will be sourced where the recipient of the income is domiciled; hence, since the Treaty grants tax authority to both the source and the residence country, income accrued on these types of contracts by U.S. residents dealing with Chilean counterparties will be only be taxable in the United States.²⁸⁶

8. *Practical Effect of the Treaty on FDI*

Considering the same facts used in section II.6 to determine the current withholding tax of USco and Chileco when doing business in Chile and the United States, respectively, the following table illustrates the withholding tax, after the Treaty is in force, on USD\$ 100 in profits — after corporate tax — for both Chileco and USco of a classic investment structure in a wholly-owned manufacturing subsidiary in each country from which 40 percent of the profits are remitted as dividends; 30 percent as interest from a regular loan; 20 percent as royalties derived from the use of software; and 10 percent as payments from services provided by the parent in the subsidiary's country.²⁸⁷

281. I.R.C. § 881(a)(1)(B).

282. S.I.I., Oficio No. 727, Apr. 1, 2011 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2011/renta/ja727.htm>.

283. S.I.I., Oficio No. 4.279, Dec. 21, 1988 (Chile), <http://home.sii.cl/sacn/oficios/JA1622.pdf>.

284. S.I.I., Oficio No. 4.619, Oct. 6, 2004 (Chile), <http://www.sii.cl/pagina/jurisprudencia/adminis/2004/renta/ja821.htm>.

285. Law No. 20544, Oct. 22, 2011 (Chile), <http://www.leychile.cl/Navegar?idNorma=1031504>.

286. *Id.* at art. 3.

287. Services are not deemed to create a permanent establishment for the purposes of this calculation.

Chileco's Investment in the U.S.				USco's Investment in Chile			
Type of Payment	Amount in U.S. Dollars	Tax Rate	Tax	Type of Payment	Amount in U.S. Dollars	Tax Rate	Tax
Dividends	40	5%	2	Dividends	40	15% ²⁸⁸	6
Royalties	30	10%	3	Royalties	30	10%	3
Interest	20	15% ²⁸⁹	6	Interest	20	15%	3
Services	10	0%	0	Services	10	0%	0
Total	100		11	Total	100		12

As the table illustrates, the withholding tax on payments or distributions to USco and Chileco is drastically reduced in both cases. For instance, the overall withholding tax on profits paid to a Chilean resident is reduced from 30 percent to 11 percent whereas withholding tax on payments made to U.S. residents decreases from 24 percent to 12 percent. The following section will analyze whether the reduction in these tax rates can have a positive impact on FDI.

IV. THE TAX CREDIT SYSTEM

This section will review two main clauses included in the Treaty that can create an impact on FDI by residents of the United States and Chile in their respective country. This part will analyze the main considerations regarding the effect of the tax credit system on the reduced tax rates under the Treaty and its effect on FDI.

1. *The Tax Credit System*

Both Chile and the United States tax their residents — and, in the case of the United States, also its citizens — on a worldwide basis. In order to relieve the effects of double taxation on income earned abroad, the U.S. and Chile grant a tax credit for taxes paid by their residents on foreign source income.²⁹⁰

288. This rate is calculated as the difference between the Additional Tax of 35 percent and the current First Category Tax of 20 percent. As a result of applying the Chile clause, there is no reduction in this rate.

289. The 15 percent tax rate is used instead of the 10 percent rate because, in accordance with Article 11, the latter rate is only applicable once the treaty has been in force for five years. Chile-U.S. Tax Treaty, *supra* note 36, art. 11, ¶ 3.

290. L.I.R. arts. 41A-C; I.R.C. § 901 (2010).

Under the tax credit system, Chile and the United States apply taxes on foreign source income and if there is a difference between the tax paid in the source country and the tax payable in the residency country, the taxpayer must pay the difference.²⁹¹ This policy is consistent with a goal of capital export neutrality, as the tax laws of the residency country will not cause foreign investment to bear a higher income tax burden than domestic investment.²⁹² If the tax paid abroad is greater than the tax payable in the residency country, no refund is granted.²⁹³

2. *Interaction Between the Tax Credit System and FDI*

In the case of Chile, the tax credit is granted with different limits based on the type of foreign source income and whether the income arises in a country with which Chile has a tax treaty in force.²⁹⁴ A 30 percent tax limit is imposed on dividends and profit distributions and a 20 percent limit is imposed on taxes on profits obtained by agencies and permanent establishments, royalties, technical services, and other similar services creditable regardless of the country from which they derive.²⁹⁵

Taxes on other types of income obtained in countries that do not have a tax treaty in force with Chile are not creditable in Chile and can only be used as a deductible expense.²⁹⁶ If a country has a tax treaty in force with Chile, the income tax on all types of income (e.g., interest, capital gains, pensions, personal services, director's fees, etc.) included in that treaty are creditable in Chile.²⁹⁷ This is an important benefit directly derived from tax treaties signed by Chile that broadens the scope of alternatives for which tax credits are granted.

An additional benefit related to income accrued in a treaty country is the CITL's provision in case of capital gain for corporate tax paid by the foreign company of which shares or rights are being sold (underlying tax) to be used as a tax credit to offset Chilean taxes on that income.²⁹⁸

291. I.R.C. § 904; L.I.R. art. 41A (A).

292. See BNA TAX MANAGEMENT, *supra* note 30.

293. Under the U.S. tax credit system this statement is always accurate. In Chile's case, an unusual exemption to this general rule is applicable under Article 41.C.3. This Article provides a tax credit for tax imposed on dependent services provided abroad, and if such tax is greater than the taxes applicable in Chile, a tax refund might be granted to the taxpayer. See S.I.I., Circular No. 25, Apr. 25, 2008 (Chile), <http://www3.sii.cl/normaInternet/#PantallaBuscador2>.

294. L.I.R. art. 41C.

295. L.I.R. art. 41A (A), (B), (C).

296. L.I.R. art. 12.

297. See L.I.R. art. 41C; Chile-U.S. Tax Treaty, *supra* note 36, art. 23, ¶ 2.

298. L.I.R. art. 41C, No. 2.

In the case of the United States, the tax is limited to the same percentage of the tax that would be applicable to such income (e.g., 35 percent in the case of corporations with taxable income over USD\$ 18.3 million).²⁹⁹ Unlike the Chilean system, which only permits a tax credit on a separated income basis,³⁰⁰ the United States' overall method allows the taxpayer to average the high and low rate countries and thus currently utilize the excess credits³⁰¹ from the higher rate countries.³⁰² As explained below, the excess tax credit position places U.S. multinational companies in a position similar to that of a company from an exempt country because they will basically only be subject to the foreign tax on that income.³⁰³

Whether the residency country has a tax credit system or an exemption system can be a determining factor in FDI. For instance, James Hines concluded that low tax rates are more likely to influence a location decision by an investor resident in an exemption regime than one in a tax credit regime.³⁰⁴

The following example will illustrate this conclusion for USco. As mentioned above, USco is a manufacturing company established in the United States, where a tax credit is granted for taxes paid in foreign countries of up to 35 percent. Assume that USco purchases 40 percent of the rights of Chileco — a limited liability company established in Chile — and USco sells its rights in this company making a profit of USD\$ 100. In accordance with Article 13 of the Treaty, the gain will be taxable at a 16 percent rate instead of the regular 35 percent Additional Tax. In consequence, USco will pay \$16 in Chile and \$19 later when profits are received in the United States (because the residency country will apply taxes on the worldwide income) for a total tax burden of \$35. Now, assume the same facts mentioned above but with the United States using the exemption method. USco will pay \$16 in Chile and \$0 in the United States for a total tax burden of \$16, which provides a net savings of \$19. This basic example explains why the tax factor is more relevant for exemption countries than for tax credit countries when FDI is located in a low income tax country.

299. I.R.C. § 904(a).

300. S.I.I., Circular No. 25, Apr. 25, 2008 (Chile), § III.1.a.

301. Under I.R.C. § 904(d)(1), a two-basket system is used in the United States to distinguish between tax credit connected to passive category income and to general category income.

302. See MCDANIEL ET AL., *supra* note 24, at 97.

303. I.R.C. §§ 901–908.

304. James R. Hines, Jr., *Tax Policy and the Activities of Multinational Corporations* 1–43 (Nat'l Bureau of Econ. Research, Working Paper Series No. 5589, 1996), http://www.nber.org/papers/w5589.pdf?new_window=1.

Other studies on FDI conclude that taxes are not relevant when an investor is deciding whether to invest domestically or abroad.³⁰⁵ This conclusion is based on two main factors: (i) capital that has been allocated abroad may be perfectly mobile between alternative foreign locations, but there is not perfect mobility between foreign and domestic locations; and (ii) the factors — different to tax — may be more relevant to determine the allocation of the corporation's activities between domestic investment and FDI.³⁰⁶

In the OECD's opinion, the tax factor becomes relevant to attract FDI only after the following determinants are met by the FDI recipient country: strong political and macroeconomic fundamentals, sizeable markets, a stable and transparent policy framework towards FDI, strong human and material resources, good infrastructure facilities, and a distortion-free economic and business environment.³⁰⁷

However, once an investor decides to invest abroad rather than domestically, taxes in potential host countries can influence the choice of location.³⁰⁸ For example, Rosanne Altshuler analyzed the effective tax rates of sixty countries where U.S. investments are located and concluded that taxes exert a strong influence on location decisions and that foreign investments of manufacturing firms are sensitive to differences in host-country tax rates.³⁰⁹

In a related study on taxation in the European Union, Griffith and Devereux concluded that both the harmonization of the statutory tax rate and the treatment of dividends have an important effect on the location of FDI by multinational companies with high levels of profitability.³¹⁰

305. Michael P. Devereux & Harold Freeman, *The Impact of Tax on Foreign Direct Investment: Empirical Evidence and the Implications for Tax Integration Schemes*, 2 INT'L TAX & PUB. FIN. 85 (1995).

306. *Id.*

307. OECD, GLOBAL FORUM ON INTERNATIONAL INVESTMENT, NEW HORIZONS AND POLICY CHALLENGES FOR FOREIGN DIRECT INVESTMENT IN THE 21ST CENTURY: FOREIGN DIRECT INVESTMENT IN DEVELOPING COUNTRIES: DETERMINANTS AND IMPACT (2001), <http://www.oecd.org/datatoecd/53/20/2407305.pdf> [hereinafter OECD GLOBAL FORUM]. This report is mainly based on previous research performed by Rolf Langhammer, Mario Levis, Friedrich Schneider, and Bruno Frey.

308. See Rosanne Altshuler et al., *Has U.S. Government Investment Abroad Become More Sensitive to Tax Rates?*, in INTERNATIONAL TAXATION AND MULTINATIONAL ACTIVITY 9–38 (James R. Hines Jr. ed., 2001)

309. *Id.*

310. Michael P. Devereux & Rachel Griffith, *Evaluating Tax Policy for Location Decisions*, 10 INT'L TAX & PUB. FIN. 107, 121 (2003), reprinted in INTERNATIONAL TAXATION 123 (James R. Hines Jr. ed., 2007).

A newer study has determined that responsiveness to tax policies has been increasingly important in recent years.³¹¹ This stems from the fact that vertical FDI, which is mainly driven by the relative cost of production, is becoming more important.³¹² Multinationals use the new globalization opportunity for minimizing tax burden by relocating mobile capital to countries with more friendly fiscal conditions.³¹³

A more recent article by Neumayer presented data on tax treaties signed with the United States, concluding that “[d]eveloping countries that sign tax treaties with the United States benefit from higher FDI originating from U.S. investors.”³¹⁴ He estimates that the increase in FDI related to a tax treaty could be as much as 20 percent to 22 percent. Nevertheless, such benefit will only occur in middle-income countries, not in low-income countries.³¹⁵

Finally, a recent article by Taro Ohno concluded that tax treaties entered into by Japan in the last twenty years had a significant, long-term, positive effect on Japanese FDI in the treaty country; however tax treaties revised during the same period showed no relevant effect on FDI.³¹⁶ Ohno estimated that “newly concluded tax treaties have a negative effect on investment in the short term, but as time passes, they increase their positive effects and in the long term, they will have a statistically significant effect.”³¹⁷ On the other hand, the revision of old tax treaties executed by Japan, aimed to reduce both double taxation and tax avoidance, did not produce any statistically significant improvements on FDI during the same period of time.³¹⁸

Based on the data analyzed here and the fact that the direct relationship between FDI and GDP has not been easily substantiated because

311. Dimitri G. Demekas et al., *Foreign Direct Investment in Southeastern Europe: How (and How Much) Can Policies Help?* 24–25 (Int’l Monetary Fund [I.M.F.], Working Paper No. 5, 2005), <http://www.imf.org/external/pubs/ft/wp/2005/wp05110.pdf>.

312. In this Article, vertical FDI is considered a counterpart of horizontal FDI, which is characterized as market-seeking FDI rather than cost-saving FDI.

313. Roberta De Santis et al., *Taxes and Location of Foreign Direct Investments: An Empirical Analysis for the European Union Countries 2*, 25–26 (Istituto di Studi e Analisi Economica, Working Paper No. 24, 2001), http://www.isae.it/Working_Papers/desantis_mercuri_vicarelli24.pdf.

314. Eric Neumayer, *Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?*, 43 J. DEVELOPING STUD. 1515 (2007).

315. *Id.*

316. Taro Ohno, *Empirical Analysis of International Tax Treaties and Foreign Direct Investment*, 6 PUB. POL’Y REV. 287, 287 (2010).

317. *Id.* at 304.

318. *See id.* at 305.

of the considerable number of variables involved, the following section examines the impact of the Treaty benefits on bilateral FDI.

3. *Effect on FDI of the Tax Credit System in Connection with the Tax Benefits of the Treaty*

In the specific case of the Treaty, a reduction in the Chilean withholding tax at source on interest, royalties, and capital gains derived from the sale of rights and shares in Chilean companies will have a very limited impact on U.S. FDI³¹⁹ in Chile based on the fact that the United States' worldwide tax system will offset such reduction with the higher corporate tax rate of 35 percent currently imposed on that income.³²⁰

Under this scenario, the decrease in Chilean withholding tax will likely only produce a shift in tax collection from the Chilean Treasury to the U.S. Treasury but will not provide a relevant benefit to U.S. investors doing business in Chile. For instance, the reduction of tax rates on capital gains by USco — connected to long term investments — in the case explained above will translate into a shift of profits from the Chilean Treasury to the U.S. Treasury of USD\$ 19 (\$35 from the applicable tax rate before the Treaty is in force minus \$16 from the applicable tax rate after the Treaty is in force) but the foreign investor will not receive a net benefit from this reduction.

The impact of the Treaty on Chilean fiscal revenues may be even greater considering the effect on other tax treaties derived from the application of the most favored nation clause. The 2 percent tax rate for certain types of royalties and, most importantly, the 10 percent tax rate on interests will force Chile to reduce its tax rates on thirteen treaties with other OECD countries that include the most favored nation clause.³²¹

To the best of this author's knowledge, the effect of the loss of revenue versus the potential increase in fiscal revenues from a potential increase in FDI has not been analyzed by Chilean authorities to determine the exact dimension of this tax expenditure.

On the other hand, the Treaty would likely have a positive effect on Chilean FDI in the United States since the tax credit will be available to new types of income such as services, interest, and certain capital gains. Furthermore, the reduction in U.S. withholding rates on interest, royalties, and especially dividends, together with the elimination of the tax on services, will not be completely offset by the Chilean corporate rate of 20 percent; thus, such reduction can increase the net return of the Chilean investor on

319. Chile does not reduce its withholding tax on dividends. *See* Chile.-U.S. Tax Treaty, *supra* note 36, Protocol, ¶ 12

320. This statement can vary if the U.S. foreign investor has an excess credit position.

321. Madariaga, *supra* note 122, at 222.

U.S. income.³²² For example, before the Treaty, the total tax burden applied to USD\$ 100 in profits paid by a wholly-owned subsidiary to its Chilean resident parent as a dividend was USD\$ 54.5; once the Treaty is in force, that amount will be reduced to USD\$ 38.25, of which up to USD\$ 30 will be creditable in Chile.³²³

Another issue to consider when determining the Treaty's impact on FDI is the limitation on benefits ("LOB") clause. In this context, the next section of this article will study the implications and scope of Article 24, which contains the limitations on benefits clause included in the Treaty, to analyze its effect on FDI.

V. THE LIMITATION ON BENEFITS CLAUSE

A LOB clause can be found in most conventions for the avoidance of double taxation entered into by the United States and in all U.S. treaties signed after 1981.³²⁴ This clause is based on the fact that the United States considers a tax treaty a vehicle for granting tax benefits to only the two contracting states and not to third jurisdictions, thus preventing the "whole world" from benefitting from a treaty signed with a given country.³²⁵

As its name indicates, the LOB clause seeks to limit the use of benefits from a tax convention by third-country residents that employ a technique known as "treaty shopping" to establish legal vehicles in countries with which the United States has signed tax conventions in order to benefit from the treaty between the U.S. and the other contracting state.³²⁶

Provisions aiming to stop tax treaty shopping deal only with the question of access to a tax treaty to a "deemed" resident of the other country, but they do not deal with issues related to the abuse of a tax treaty and recharacterization of income.³²⁷

In order to determine whether a person may or may not be entitled to the benefits of the Convention, Article 24 includes a series of tests designed to objectively determine whether benefits should be granted.³²⁸ In effect, if

322. Since the tax rates of 20 percent and 18.5 percent are only applicable for 2011 and 2012, respectively, this Article assumes for all purposes that the effective corporate rate is 17 percent.

323. The calculations are as follows: Before Treaty: $100 * 0.35 + 65 * 0.30 = 54.5$. After Treaty: $100 * 0.35 + 65 * 0.05 = 38.25$.

324. See BITTKER & LOKKEN, *supra* note 41, ¶ 67.3.3, at 67–72.

325. See MCDANIEL ET AL., *supra* note 24, at 182–184.

326. The comments on Article 1 of the OECD Model for Avoiding Double Taxation include a proposed clause that is similar, although less specific, to the Convention.

327. David Ward et al., *How Domestic Anti-avoidance Rules Affect Double Taxation Conventions*, 19c IFA CONGRESS SEMINAR SERIES (1994).

328. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 22.

the taxpayer complies with any of the tests indicated in the clause, it will be considered to have a real business objective in the country of residence, or a connection of such relevance with that country that the taxpayer will be given access to the treaty benefits.³²⁹

From a practical point of view, the LOB clause aims to prevent treaty shopping by assuming that a company established in the contracting state that is owned substantially by residents of that contracting state and does not make relevant tax-deductible payments to third countries was probably not established by residents of other countries to improperly take advantage of the benefits of the Treaty.³³⁰

Also, if the company does not meet these conditions but does actively conduct trade or business in the other contracting state, it can secure the treaty benefits for certain income derived from this trade or business. Additionally, if a company does not satisfy any of the above requirements, it can ask the competent authority of the other country to grant the benefits of the Treaty.³³¹

It is important to point out that the LOB rules are not exclusive of internal law provisions that seek to limit abuse of domestic law in order to obtain tax benefits.³³² In effect, internal law can be used to identify the beneficial owner of income and the LOB clause can be applied to determine whether that beneficial owner can or cannot receive the treaty benefits for that income.³³³

1. *Residents Qualified to Receive the Benefits of the Treaty*

A resident of a contracting state will be considered qualified to receive the benefits of the Convention if the resident is:³³⁴

- a) An individual resident of one of the contracting states;
- b) The signing country or any political subdivision, local authority, agency, or body of that country;
- c) A pension fund, as long as more than 50 percent of its beneficiaries, members, or participants are persons that are residents of the other country;
- d) A non-profit entity established for religious, charity, educational, or other similar purposes;

329. *Id.*

330. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(g).

331. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶¶ 3(a), 4.

332. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 22,

¶ 1.

333. *Id.*

334. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2.

e) A company whose shares are regularly traded on one or more stock exchanges or a company that is a subsidiary of a company whose shares are regularly traded on a stock market.³³⁵

However in both cases, the latter company must also meet either one of the following additional requirements: (i) The main class of shares is traded on one or more exchanges in its country of residence; or (ii) the company's primary place of management and control is in the company's country of residence.³³⁶

The benefits of the Treaty will also be granted to a company if at least 50 percent of its shares are held by five or fewer companies whose shares are traded on recognized stock exchanges.³³⁷ Should indirect ownership exist, each owner must be a resident of Chile or the United States.³³⁸

f) A person that functions as a "headquarters company" for a multinational corporate group. For these purposes, "headquarters company" is defined as an entity that meets the following copulative conditions:

(i) carries out overall supervision and administration — discretionally or independently — of a group of companies in the country where it resides; (ii) the corporate group to which it belongs is engaged in active business in at least five countries, generating in the aggregate 10 percent or more of the group's gross income but with no one country generating more than 50 percent of the group's gross income; (iii) does not obtain more than 25 percent of its gross income from the other contracting state; (iv) is subject to the general tax rules established for companies engaged in the active trade or business; and (v) the income it generates in the other state either is obtained in connection with, or is incidental to, the

335. Article 24 of Chile-U.S. Tax Treaty also limits evasion of these rules through the creation of "disproportionate shares," or shares that entitle shareholders to the right to a disproportionately higher participation through dividends, redemption payments, or other types of payments. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(c).

336. Pursuant to Article 24 of the Treaty, the primary place of management and control is located in the country where the executive officers and senior management employees exercise more day-to-day responsibility for the strategic, financial, and operational policy decision making for the company than in any other country and where the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions than in any other country. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(c)(i).

337. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2 (c)(ii).

338. *Id.*

group's active business.³³⁹ Despite the rigid nature of this provision, it is somewhat flexible since the Treaty establishes that if the above percentages are not met, average income from the four preceding years can be used to calculate these percentages.³⁴⁰ This means that the benefits of the Treaty cannot be denied as a result of very poor or very successful earnings in a specific year.

g) A legal entity that meets the "ownership/base erosion" test.³⁴¹ This test seeks to limit companies being established in contracting states with the sole purpose of receiving the benefits of the Treaty. In practice, a person is considered qualified to receive the benefits of the Treaty if 50 percent or more of each class of shares or interests is owned directly or indirectly for at least half of the tax year by a person that is a beneficiary of the Convention under the terms indicated above³⁴² and, also, less than 50 percent of the gross income of that person is paid to non-beneficiaries of the Treaty via tax-deductible payments.³⁴³ Examples of tax-deductible payments include interest, royalties, and services, except for arm's length payments for services or goods during the normal course of business.

h) A person that does not qualify for the benefits of the Treaty based on the rules above may still be entitled to the Treaty benefits for a specific item of income derived from the country from which the income is paid (source country) related to the active conduct of a trade or business in the other state (country of residence).³⁴⁴ For this benefit to apply, the income should be derived from business other than making or managing investments, unless in the case of banking, insurance, or securities activities carried on by a bank, insurance company, or registered securities dealer (in which

339. In conformity with Article 24, paragraph 2(d)(ii) of the Treaty, this group of companies can include, but not consist primarily of, a financial group. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2 (d)(i).

340. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(d).

341. BITTKER & LOKKEN, *supra* note 41, ¶ 67.3.3, at 67–75.

342. In the case of indirect ownership, each owner shall be considered a resident of that contracting state. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(g)(i).

343. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 2(g)(ii).

344. For these purposes, Article 24, paragraph 3(c) sets forth that "activities conducted by persons connected to a person shall be deemed to be conducted by such person." The concept of connected persons includes interests equal to or greater than 50 percent of the beneficial interest of one company in another, or "if, based on all the relevant facts and circumstances, one person has control of the other or both are under the control of the same person or persons." Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 3(c).

case such activities are accepted). Furthermore, active development of a trade or business in the country of residence should be “substantial” with respect to the source country activity.³⁴⁵ To determine whether an activity or business is substantial, all the facts and circumstances related to that activity or business shall be analyzed.³⁴⁶

i) A person who does not meet any of the conditions in paragraphs a) to g) for qualifying as a beneficiary of the Treaty and does not satisfy the requirements of paragraph h) for a given item of income to be entitled to receive the benefits of the Convention can be a beneficiary if the competent authority of the other contracting state decides to grant it these benefits.³⁴⁷ For these purposes, the authority shall consider whether one of the main purposes for acquiring or maintaining such person or of its business operations is to obtain benefits under this Treaty.³⁴⁸ A taxpayer is also entitled to present his case to the relevant competent authority for an advance determination based on the facts.³⁴⁹

Lastly, paragraph 5 of Article 24 of the Treaty sets forth that income obtained in the source country that is attributable to a permanent establishment in a third country shall not be entitled to receive the benefits of this Convention.³⁵⁰ This holds true as long as the tax paid for that income in the country of residence of the PE’s parent company plus the tax paid in the third country is less than 60 percent of the tax that would have been paid in the country of residence if the income had been obtained in that country.³⁵¹ Dividends, interest, and royalties in this particular situation shall be taxed in the source country, but the rate shall not exceed 15 percent of the gross amount paid. Any other income shall be subject to general taxation rules under domestic law.³⁵²

This latter rule should be carefully studied in the case of dividends since this provision could conflict with paragraph 12 of the Treaty’s Protocol, which establishes that paragraphs 2, 3, 7, and 8 of Article 10 do not limit the application of the Additional Tax (withholding tax) to the extent that, in accordance with Chilean domestic law, First Category Tax is fully

345. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 3(b).

346. Special attention should be given to the relative size of the economies of the contracting states. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 22, ¶ 3.

347. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 4.

348. *Id.*

349. U.S. 2006 MODEL TECHNICAL EXPLANATIONS, *supra* note 119, art. 22, ¶ 4.

350. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 5.

351. *Id.*

352. *Id.*

deductible when calculating additional tax payable. The problem arises since paragraph 5 of Article 24 is not expressly included in paragraph 12 of the Protocol; hence, Chile shall be obligated to decrease its Additional Tax from 35 percent to 15 percent in this case. This unintended situation will be unique in Chilean tax treaty policy since Chile has never agreed to decrease its tax authority on dividends because, as mentioned above, it considers that an overall tax burden of 35 percent is fair enough for foreign investors.

Notwithstanding, the restrictions set forth in paragraph 5 do not apply if the payments are for royalties received as compensation for the use of intangible property produced or developed by the PE or for any other income derived in connection with, or incidental to, the active development of a trade or business by the PE in the third country.³⁵³

2. *Effect of the Limitation on Benefits Clause on FDI*

The LOB clause makes significant progress in international tax law for the avoidance of abuse from treaty shopping, imposing a series of restrictions on companies that are established in a given country in order to obtain the benefits of a convention entered into with the United States.

However, a measure aimed at reducing tax avoidance can have a negative effect on FDI. For instance, Ohno analyzes several factors of tax treaties that can unfavorably impact FDI and the LOB clause is among the first in the list.³⁵⁴

This result is, in the opinion of this author, due to four reasons:

(i) it denies the benefit to companies owned by foreign individuals for reasons other than purely economic grounds such, as political stability and tax savings;³⁵⁵

(ii) the strict screening of persons eligible for the benefits of the treaty beforehand, under the exchange of information clause, may be regarded as a potential unwanted audit of the companies and its owners;³⁵⁶

(iii) the complexity of applying this clause requires reviewing and adapting diverse legal structures and business units used by multinationals established in Chile to conduct business in both Latin America and the United States since, although their principal objective for establishing companies in Chile might not be

353. Notwithstanding this exception, Article 24, paragraph 5(b), sets forth that the business of investing, managing, or simply possessing investments on behalf of the company shall be subject to general taxation rules under the domestic law of the source country. Chile-U.S. Tax Treaty, *supra* note 36, art. 24, ¶ 5(b).

354. Ohno, *supra* note 316, at 294.

355. For instance, in recent years Venezuelan and Argentinean companies have formed companies in Chile to avoid the political instability of those countries.

356. *See* Chile-U.S. Tax Treaty, *supra* note 36, art. 27.

tax-related, they could be denied the benefits of the Convention because of limitations imposed by this clause; and

(iv) the LOB can produce an undesired effect related to derivative benefits.³⁵⁷ Indeed, the Treaty does not include a provision that extends the benefits under the Treaty to companies owned by foreign persons that are residents of another treaty country unlike other treaties signed by the United States, such as those with Canada, Denmark, Ireland, the Netherlands, Switzerland, and Finland.³⁵⁸

This will mainly affect multinational companies from European countries that have a treaty in force with both Chile and the United States, since the benefits of both treaties might be denied if they conduct their investment in the United States through Chile. Even if the benefits of the Treaty are granted by the U.S. Competent Authority, there is no certainty as to what tax rate will be applied by the United States if the withholding tax between Chile and the United States is different than that agreed upon in the tax treaty between the United States and the third country.

An additional perspective connected to the LOB clause is the denial of Treaty benefits under the concept of a “platform company” to a company established in Chile that uses the special regime established by Article 41D of the CITL. This kind of structure is mostly used by investors domiciled in other Latin American countries (e.g., Argentina, Venezuela, and Bolivia) that seek asset protection in Chile given the uncertainties in their domestic legal and economic frameworks. Under a platform company regime, if the entity meets several conditions and invests abroad, it does not pay taxes in Chile with respect to foreign source income. However, the Treaty benefits would likely be denied under the LOB requirements.³⁵⁹

Notwithstanding the aforesaid, the application of the LOB clause might also create collateral benefits for Chile because it will likely encourage foreign investors to pursue a greater level of investment and establishment (i.e., more expenditure on labor force and acquisition of facilities) in Chile in order to be eligible for Treaty benefits. However, if Ohno is right, it is unlikely that benefits derived from this potential increase on FDI can offset the reduction on FDI derived from the LOB clause.

VI. CONCLUSION

357. For more detailed analysis on this matter, see Ruth Mason, *When Derivative Benefits Provisions Don't Apply*, 112 TAX NOTES 367 (2006).

358. Richard L. Reinhold, *What Is Tax Treaty Abuse? (Is Treaty Shopping an Outdated Concept?)*, 53 TAX LAW. 663, 690 (2000).

359. See L.I.R. art. 41D.

The Treaty will reduce withholding rates at source on interest, royalties, and capital gains and will exempt income derived from services and business profits not attributable to a permanent establishment.

In the case of Chilean investment in the United States, an increase in Chilean FDI can be expected since the reduction in withholding tax by the United States will not be fully offset by Chilean taxes on such payments. Furthermore, it can be argued that the existence of the Treaty has a positive effect on investors' attitudes and willingness to invest and, hence, may positively affect FDI. Since there are no tax treaties in the region — other than the U.S.-Mexico and U.S.-Venezuela tax treaties — the Treaty may also attract investment that goes through Chile for tax savings purposes but that also meets the requirements under the LOB clause.

In contrast, it is unclear whether the decreased withholding tax will increase U.S. FDI in Chile, because such decrease will likely be offset by the U.S. tax credit system. Consequently, the Treaty's most direct effect is not a reduction in the tax burden of the U.S. investor but rather a shift in tax revenues from the Chilean Treasury to the U.S. Treasury.

The Treaty's effect on Chilean revenues and the country's welfare can be even greater if the impact of the most favored nation clause included in tax treaties signed with OECD members is taken into account. Even if FDI increases as a result of the Treaty, there is no empirical evidence that such an increase — and its potential favorable effect on the First Category Tax — will create a net benefit for Chile that compensates the loss of revenues arising from the Treaty.