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Broader Implications of Senate Action on U.S.-Chile Tax Treaty

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INTRODUCTION

More than 10 years ago, the U.S. and Chilean governments signed an income tax treaty (''the Treaty''),[1] but the Treaty has languished in the U.S. Senate along with other proposed tax treaties. The Treaty would represent a major step forward in the trade and investment relationship between the United States and Chile, and the business community is eagerly awaiting the Treaty's ratification and entry into force.[2] The Senate Finance Committee recently approved the Treaty, subject to two reservations.[3] If the full Senate were to approve the Treaty subject to these reservations with a two-thirds majority vote, the Treaty would go back to the Chilean Congress for that country to approve the reservations and clear the way for the two countries to exchange instruments of ratification. It is certainly long past time for the Senate to clear this and other pending tax treaties, and enable the country to resume a normal program of treaty making in the tax area.

The two reservations proposed by the Senate Foreign Relations Committee both relate to the interaction of key aspects of the 2017 Tax Cuts and Jobs Act (TCJA)[4] with standard provisions of U.S. tax treaties. One relates to the base erosion and anti-abuse tax of §59A (BEAT),[5] and the other relates to the elimination of the indirect foreign tax credit under §902 and the enactment of a dividends-received deduction under §245A. These issues are not specific to Chile, and thus the Committee's proposed reservations presumably represent a model for future U.S. tax treaties.[6]

OVERVIEW OF THE TREATY

The Treaty is broadly consistent with the 2016 U.S. Model Income Tax Treaty, with some departures, including measures permitting a greater degree of source-country taxation in several respects. Key provisions of the Treaty include reduced withholding tax rates on dividends (5% or 15%, depending on level of stock ownership), interest (4% for financial institution lenders, otherwise 15%),[7] and royalties (generally 10%, but 2% for royalties paid for the right to use industrial, commercial, or scientific equipment), the allowance of a source-country withholding tax on gain from certain dispositions of stock (at a rate of 16%),

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[1] *Convention between the Government of the United States of America and the Government of the Republic of Chile for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and Capital* (signed February 4, 2010).

[2] *See, e.g.*, Letter from Chamber of Commerce to Senators Bob Menendez and Jim Risch (Mar. 17, 2022), (''Approval of this treaty has become an urgent priority for U.S. companies doing business in Chile.'').

[3] *See* Sen. Comm. on Foreign Relations Exec. Rpt. 117-1, *Tax Convention with Chile*, 117th Cong., 2d Sess. (Apr. 7, 2022) (the SFRC Report).

[4] Pub. L. No. 115-97 (Dec. 22, 2017).

[5] All section and ''§'' references are to the Internal Revenue Code of 1986, as amended (the ''Code''), or related Treasury regulations, unless otherwise indicated.

[6] It is assumed that the U.S. Treasury Department supports the Committee's proposed reservations. The SFRC Report indicates that at least the second reservation, dealing with the elimination of the indirect credit under §902, was ''[b]ased on discussions with the U.S. Department of the Treasury.'' *See* SFRC Report, at 4.

[7] The general interest withholding tax rate of 15% is further lowered to 10% after the Treaty has been in force for five years.

a permanent establishment (PE) provision that includes a services PE rule, and a robust limitation-on-benefits (LOB) provision.

The Treaty would be only the third U.S. income tax treaty with a Latin American country (the others being Mexico and Venezuela), and thus is considered an important step forward not just in the trade and investment relationship between the United States and Chile, but also in U.S. economic relations in the region.

RESERVATION #1: BEAT

The first reservation recommended by the Senate Foreign Relations Committee protects the U.S. ability to impose the BEAT. The text of this reservation is as follows:

> Nothing in the Convention shall be construed as preventing the United States from imposing a tax under section 59A, entitled the ''Tax on Base Erosion Payments of Taxpayers with Substantial Gross Receipts,'' of the Internal Revenue Code (as it may be amended from time to time) on a company that is a resident of the United States or the profits of a company that is a resident of Chile that are attributable to a permanent establishment in the United States.[8]

This reservation addresses the uncertainty that currently exists regarding the interaction between the BEAT and U.S. bilateral tax treaties. In enacting the BEAT in 2017, the Congress included nothing in the statutory language nor in the legislative history to indicate any intent to override tax treaties. This is noteworthy, as two standard tax treaty provisions arguably could operate as a limit on the BEAT: the nondiscrimination article (as the BEAT effectively disallows deductions for payments to foreign related persons) and the double taxation relief article (as the BEAT does not allow a foreign tax credit).[9] The proposed reservation would eliminate any doubts about the U.S. ability to apply the BEAT in the context of this particular treaty, although query what inference might be drawn from the perceived need for the reservation in the context of other treaties.

RESERVATION #2: INDIRECT FOREIGN TAX CREDIT

The second reservation recommended by the Senate Foreign Relations Committee modifies the double-taxation relief article of the Treaty to reflect the TCJA's elimination of the indirect foreign tax credit rule of §902 and its enactment of a dividends-received deduction under §245A. As amended, the first paragraph of the article would read as follows:

> In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle thereof): a) the United States shall allow to a resident or citizen of the United States as a credit against the United States tax on income applicable to residents and citizens the income tax paid or accrued to Chile by or on behalf of such citizen or resident. For the purposes of this subparagraph, the taxes referred to in subparagraph b) of paragraph 3 and paragraph 4 of Article 2 (Taxes Covered), excluding taxes on capital, shall be considered income taxes; and b) in the case of a United States company owning at least 10 percent of the aggregate vote or value of the shares of a company that is a resident of Chile and from which the United States company receives dividends, the United States shall allow a deduction in the amount of such dividends in computing the taxable income of the United States company.[10]

Thus, whereas U.S. income tax treaties historically have included a commitment to provide an indirect foreign tax credit on earnings that come into the United States as dividends or subpart F inclusions, the new language would eliminate any treaty-based commitment to provide an indirect credit and instead would promise a dividends-received deduction, subject to the limitations of U.S. internal law (i.e., §245A).

Notable in the proposed language is the absence of any treaty-based commitment by the United States to allow the 80% deemed-paid foreign tax credit under §960(d) in connection with inclusions under the TCJA's global intangible low-taxed income (GILTI) provisions. This might not matter, insofar as §960(d) itself allows the credit, and thus the question whether the treaty also requires the allowance of the credit might be academic. On the other hand, the treaty-based guarantee of foreign tax credits presumably has been thought to serve some purpose, insofar as it has been included in many decades of U.S. tax treaties, and there would seem to be no reason to introduce a new disparity between the scope of the U.S. internal law credit and the scope of the treaty-based credit.

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[8] *See* SFRC Report, at 5.

[9] *See, e.g.*, 2016 U.S. Model Income Tax Treaty, arts. 23 (double taxation relief) and 24 (nondiscrimination). For a detailed exposition of these issues, see H. David Rosenbloom and Fadi Shaheen, *The BEAT and the Treaties*, 92 Tax Notes Int'l 53 (Oct. 1, 2018).

[10] *See* SFRC Report, at 5.

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Moreover, the recently finalized foreign tax credit regulations[11] could make these distinctions more than academic, as the new regulations add creditability restrictions that would apply outside the treaty context but not within the treaty context.[12] While the author is not aware of any concern that the new regulations as currently formulated present any creditability problems with respect to the Chilean corporate income tax as currently formulated, it would nevertheless be desirable (under any U.S. tax treaty) for taxpayers to be able to rely on a treaty-based guarantee of the indirect credit with respect to their GILTI inclusions, as protection against the possibility of further changes to the regulations.

With respect to that treaty-based guarantee, another deviation from U.S. standard treaty language also should be noted. The standard treaty language protects the U.S. ability to apply various limitations on the foreign tax credit under U.S. internal law (e.g., separate baskets under §904), ''as it may be amended from time to time without changing the general principle *hereof*.''[13] The ''hereof'' in the standard treaty language refers to the principle of treaty-based double taxation relief, and thus suggests the existence of some treaty-based limit to the kinds of changes to U.S. internal law that the treaty can accommodate. The corresponding language in the Senate Foreign Relations Committee's proposed reservation, on the other hand, changes ''hereof''' to ''thereof,'' thereby making U.S. internal law tax principles rather than tax treaty principles the yardstick of whether a change to U.S. internal law would violate the treaty-based commitment to provide a credit.[14] This would seem to be a bit circular, and could serve as something of a dilution of the treaty-based guarantee of a credit.

CONCLUSION

While the Treaty is undeniably important in the context of the U.S.-Chile trade and investment relationship and U.S. economic relations with Latin America in general, it is also of broader interest as an early example of how U.S. tax treaty policy is evolving to adapt to the very major changes made by the TCJA in 2017. Hopefully the Treaty will be ratified and enter into force soon. Taxpayers and policy makers also should be aware of the broader tax treaty issues that have been addressed in the Senate approval process and consider where the evolving U.S. tax treaty policy currently stands with respect to the interaction between the BEAT and tax treaties, and the nature and extent of treaty-based rights to foreign tax credits.

[11] T.D. 9959 (Jan. 4, 2022).

[12] *See* Reg. §1.901-2(a)(1)(iii).

[13] *See, e.g.*, 2016 U.S. Model Income Tax Treaty, art. 23(2) (emphasis added).

[14] The same observation would apply to the new treaty-based guarantee of a dividends-received deduction.

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