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Future of United States – Chile Bilateral Tax Treaty Remains Uncertain

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On February 4, 2010, after more than a decade of negotiations, government officials from the *United States* and ***Chile*** executed the first *bilateral income tax treaty* ("Tax Treaty") between the two countries. This event marked an important next step in economic cooperation; the ***United States-Chile Free Trade Agreement***, which entered into force on January 1, 2004, had already significantly increased free trade by removing tariffs, reducing barriers, and providing necessary legal protections for investors from both countries. The Tax Treaty was designed to further encourage the stream of cross-border investments and widen the United States' tax treaty network in Latin America beyond Mexico and Venezuela.

However, 7 years later, the Tax Treaty has not yet entered into force – while it was approved by the Chilean Congress in 2015, it has not been ratified by the U.S. Senate. The Senate Foreign Relations Committee approved the Tax Treaty in both 2011 and 2015, but Senator Rand Paul (R-KY) has placed a hold on the Tax Treaty, along with tax treaties with 7 other countries, due to concerns that the exchange of information provisions infringe on personal privacy, blocking their consideration by the full chamber. To date, no compromise has been reached, and the future of the Tax Treaty remains uncertain, particularly under the current administration. President Trump's trade policies seem so far to prioritize the review of the United States' existing free trade agreements – and in the case of the North American Free Trade Agreement (NAFTA), even renegotiation.

Recent corporate tax hikes in Chile have further highlighted the need for a United States-Chile tax treaty. Under a new Chilean tax law that went into effect on October 1, 2014, corporate tax rates are gradually increasing and are scheduled to reach a peak in 2018. Moreover, as part of the tax reform legislation, Chile implemented a dual tax system in early 2017 requiring company shareholders to select one of two tax regimes: (1) a fully-integrated regime under which shareholders are taxed at an effective tax rate of 35% of their share of company profits as they accrue annually; or (2) a partially-integrated system under which shareholders are taxed at a higher effective tax rate of 44.45% but only when profits are distributed. Both tax regimes have a negative impact on shareholders' dividend income since the fully-integrated regime preserves the pre-tax reform effective tax rate but deprives shareholders from deferral of recognition of income, while the partially-integrated system allows for such deferral but raises the effective tax rate significantly.

Typically, an income tax treaty protects investors against the effects of such tax increases by setting a threshold on dividend withholding tax (e.g., 5, 10 or 15%). In its current form, the Tax Treaty contains a dividend withholding provision, but only in favor of Chilean resident shareholders receiving dividends from United States corporations. Thus, United States investors will not be able to rely on the Tax Treaty in its current form for complete protection from the negative impacts of the new tax regime, and may have to turn to other alternatives, such as investments through intermediary foreign entities.

We will continue to monitor the progression of the Tax Treaty in the U.S. Senate and whether President Trump seeks to revise it to address privacy concerns and secure further protections for U.S. investors.

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