Executive summary

On 22 January 2016, representatives of Japan and Chile signed an income tax treaty (Treaty) and protocol (Protocol). This is the first Treaty signed by the two countries.

The Treaty reflects the provisions in the current Organisation for Economic Co-operation and Development (OECD) Model Convention as well as recommendations in the OECD final reports in its Action Plan on Base Erosion and Profit Shifting (2015 BEPS Reports). The Treaty includes the following key provisions:

- Introduction of a fiscally transparent entity/arrangement concept (Article 1)
- Inclusion of a service permanent establishment (PE) (Article 5)
- Introduction of business income under Article 7 of the OECD Model Treaty amended in 2010, which adopted the Authorized OECD Approach (AOA) (Article 7)
- Withholding taxes for dividends, interest and royalties (Articles 10, 11 & 12)
- Source country capital gains on certain share dispositions (Article 13)
- Principal purpose tests for the limitation of relief (Article 22)
- Mandatory arbitration in Mutual Agreement Procedures (MAP) (Article 25)
The Treaty and Protocol will enter into force after the exchange of ratification instruments. The provisions of the Treaty and Protocol will become effective for both countries as of 1 January of the year following entry into force.

This Alert summarizes the key provisions of the Treaty and the Protocol.

Detailed discussion

**Fiscally transparent entity/arrangement concept – Article 1**

The Treaty states that income derived by or through an entity or arrangement that is treated as wholly or partly fiscally transparent under the tax law of either Contracting State would be considered to be income of a resident of a Contracting State but only to the extent that the income is treated as the income of a resident of that Contracting State for purposes of taxation by that Contracting State.

The term “fiscally transparent” means that, under the tax law of a Contracting State, income or part of the income of an entity or arrangement is not taxed at the level of the entity or arrangement but at the level of the persons who have an interest in that entity or arrangement as if that income or part thereof were directly derived by such persons at the time when that income or part thereof is realized whether or not that income or part thereof is distributed by that entity or arrangement to such persons.

**Service PE – Article 5**

Paragraph 3(b) of Article 5 contains the following service PE definitions:

The furnishing of services, including consultancy services, by an enterprise through employees or other individuals engaged by the enterprise for such purpose but only if activities of that nature continue within a Contracting State for a period or periods aggregating more than 183 days within any 12-month period commencing or ending in the taxable year concerned.

The duration of activities under Paragraph 3 (b) of Article 5 would be determined by aggregating the periods during which activities are carried on in a Contracting State by related companies, provided that the activities of such a related company in that Contracting State are connected with the activities carried on in that Contracting State by its related companies. The period during which two or more related companies are carrying on concurrent activities would be counted only once for the purpose of determining the duration of activities.

**Business income – Article 7**

The Treaty provides taxation on business income attributable to a PE (such as a branch, including the service PE), which is in line with the Article 7 of AOA. Under the provision, business income attributable to the PE will be calculated based on the arm's length principle as if the PE were a separate and independent enterprise from its head office.

**Dividends – Article 10**

The Treaty provides three withholding tax rates as follows:

- A full exemption on dividends if the beneficial owner of the dividends is a pension fund.
- A 5% rate, if the beneficial owner of the dividends is a company that has owned directly at least 25% of the voting power of the company paying the dividends for at least six months.
- A 15% rate applies in all other cases.

However, the above provisions do not limit the application of the additional tax payable in Chile.

**Interest – Article 11**

The Treaty provides a 4% withholding tax rate on interest paid to a bank, an insurance company and certain companies that conduct a lending or finance business; whereas in all other cases, a 10% rate applies.¹

**Royalties – Article 12**

The Treaty provides a 2% withholding tax rate on royalties for the use of, or the right to use, industrial, commercial or scientific equipment and a 10% in all other cases.

**Capital gains – Article 13**

The Treaty grants the right to tax on gains derived from the transfer of the following shares:

- Representing 20% or more of the capital of a company, owned directly or indirectly at any time during the 365 days preceding the transfer, other than gain derived by a pension fund
(ii) Deriving at least 50% of the value of its property directly or indirectly from immovable property situated in that other Contracting State at any time during the 365 days preceding such transfer

(iii) Other than (i) and (ii) above (the tax rate on this gain is limited to 16%)

**Limitation of relief – Article 22**

Reflecting the recommendation in the 2015 BEPS Final Reports on Action 6, Article 22 of the Treaty provides that a benefit under the Treaty will be denied if obtaining the benefit under the Treaty is one of the principle purposes of any arrangement or transaction that would result directly or indirectly in that benefit.

In addition, if certain income is treated as being attributable to a PE of a third country, the benefit on such income will be denied if (i) the combined tax actually paid with respect to such income in the Contracting State and in that third country is less than 60% of the tax that would have been payable on such income in the Contracting State if the income were accrued or received in the Contracting State by the company, that were not attributable to the PE in that third country; or (ii) the PE of a third country does not have a comprehensive tax treaty with the other Contracting State from which the benefits of the Treaty are being claimed, unless the income attributable to the PE is included in the tax base of the company in the Contracting State. Any income that is denied the benefit would be taxed under the domestic law of the Contracting State. However, a withholding tax rate on any interest or royalties under these provisions would not exceed 25% of the gross amount.

**Mandatory arbitration – Article 25**

Paragraph 5 of Article 25 explicitly provides for mandatory arbitration proceedings, in which the cases not being resolved between the tax authorities of the Contracting States will be resolved pursuant to decisions made by third party arbitrators if the taxpayer requests.

**Protocol**

Article 7 of the Protocol states that if Chile concludes a treaty with a country other than Japan and the provisions of such treaty include more favorable treatment than the ones in the Treaty, at the request of Japan, the two countries would consult on amending the Treaty.

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**Endnote**

1. For two years from the effective date of the Treaty, a 15% rate applies in lieu of the 10%.
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