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New Protocol to Modernize 1990 US-Spain Income Tax Treaty

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Introduction

The existing income tax treaty between the United States and Spain dates back to early 1990. Taking into account the changed circumstances and the development of tax law in both nations, in January of 2013, the United States and Spain signed an agreement amending the existing treaty.The 2013 protocol ("protocol") and corresponding memorandum of understanding bring the agreement in line with current U.S. tax policies. When ratified by both nations, the effect will be drastically reduced tax barriers in the areas of dividends, interest, royalties and capital gains. In addition, there has been a substantial overhaul of the limitation of benefits ("LOB") provision, making some elements more restrictive but also providing additional tests under which benefits may be granted.

This article analyzes the changes to Articles 10 through 13 of the convention, respectively dealing with the taxation of dividends, interest, royalties and capital gains.In addition, there have been substantial updates to Article 17, the LOB provision, which will also be considered.

This analysis will examine the 1990 treaty ("treaty") and the protocol, with reference to the 2010 OECD Model Tax Convention ("OECD model"), the 2006 United States Model Income Tax Convention ("U.S. model"), and various recent U.S. bilateral agreements.

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1. Dividends – Article 10

A number of changes can be seen when comparing the protocol to the existing treaty. **The two most significant changes to the treatment of dividends are the reduction in general withholding tax between associated companies and, in some situations, the complete elimination of withholding for parent companies.**

In conformity with the treaty and the OECD model, the protocol does not prescribe exclusive taxation of dividends in either the state of the beneficiary's residence, or the state in which the company paying the dividends is a resident. As granting exclusive rights to one state would be unfeasible, the article allows the beneficial owner's ("B.O.") state of residence to tax the dividends, while also granting a limited right of taxation to the Contracting State of which the paying company is a resident[2].

The general withholding tax rate of 15% has been left unmodified. This rate is consistent with both the US model and the OECD model. However, the two more preferable rates, the rate between associated companies, and the parent-subsidiary rate have been reduced.

The 1990 treaty allows a withholding of up to 10% when dealing with associated companies, if the beneficial owner is a company that owns directly at least 25% of the voting stock of the company paying the dividends. The protocol not only lowers the withholding rate from 10% to 5%, it also reduces the ownership requirement from 25% to 10%.

When dealing with a parent-subsidiary dividend, the protocol provides even more favorable conditions by completely eliminating the withholding tax. The withholding exemption is limited to parent companies, if the parent company is a resident of the other Contracting State and has held (directly or indirectly) 80% or more of the voting stock in the paying company for a twelve month period preceding the date on which entitlement to the dividends is determined[3].

2. Interest – Article 11

In conformity with other recent protocols, the agreement eliminates source state taxation with respect to interest, granting exclusive taxation to the B.O.'s state of residence.

[2]"Taxation of dividends exclusively in the State of course is not acceptable as a general rule." OECD (2012), "Commentary on Article 10: Concerning the Taxation of Dividends", in *Model Tax Convention on Income and Capital 2010: Full Version,* OECD Publishing.
[3]In order for the beneficial owner to qualify for the exemption, the beneficial owner must also satisfy Article 17(2) (c), Article 17(2) (e), Article 17(3), or Article 17(7).

Under the treaty, interest arising in one Contracting State and derived by a resident of the other Contracting State was taxable in the latter. Additionally, the Contracting State in which the interest arose was permitted to tax at a rate not to exceed 10%. The rate of 10% was, and is, consistent with the OECD model and said to be a "reasonable maximum bearing in mind that the state of source is already entitled to tax profits or income produced on its territory by investments financed out of borrowed capital."[4]

While the 10% rate is reasonable under most circumstances, in the case of Spain and the United States, any withholding makes investment between the two nations much less likely as U.S. institutions receive less beneficial treatment than EU institutions. Under the current treaty, payments made to U.S. B.O.'s are subject to a 10% withholding. In contrast, payments made to B.O.'s in other EU member states are exempt from any withholding. Subject to a few particularities,[5] the new protocol eliminates this disparity by removing the withholding tax.

The removal of the at source withholding tax should be seen as a positive sign, particularly for U.S. banks and institutions looking to invest in Spain, and for Spanish companies looking for U.S. based capital.

3. Royalties – Article 12

In line with the treatment of interest payments, the most significant change made by the protocol concerning royalties is the general elimination of source state taxation.

Under the treaty, in addition to taxation by the state of residence of the company benefiting from royalty payments, the source state is permitted to levy a withholding tax at a rate of 5%, 8%, or 10% depending on the nature of the royalty[6].With the exception of para. 3, dealing with special cases of

[4] OECD (2012), "Commentary on Article 11: Concerning the Taxation of Interest", in *Model Tax Convention on Income and Capital 2010: Full Version,* OECD Publishing.

[5] Notwithstanding the general removal of the withholding tax, the U.S. reserves a right to "contingent interest of a type that does not qualify as portfolio interest under United States law," but if the B.O. is a resident of Spain, such tax may not exceed 10%. Additionally, the United States may tax interest that is an excess inclusion with respect to a residual interest in a real estate mortgage investment conduit, in accordance with its domestic laws. Art. 11(2), Protocol Amending the Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, January 14, 2013 [hereinafter "Protocol"].

[6] A 5% rate is applied to literary, musical dramatic or artistic work, an 8% rate was applied to films and the like, as well as industrial or commercial rights, and a 10% rate was applied to "all other royalties."Art. 12(2), Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, February 22, 1990 [hereinafter "Treaty"].

permanent establishments, only the state of the beneficial owner's residence may tax the royalty payments.

Additionally, the protocol updates the definition of royalties. Under the current treaty, royalties included consideration for common forms of copyright including, inter alia, literary, musical, artistic and scientific works. The definition further classifies payments for technical assistance as royalties, where the assistance is related to the application of the previously mentioned intangibles. While the protocol has not made any significant amendments to the underlying intangibles, the clause relating to technical assistance has been removed. By removing any mention of technical assistance, the protocol brings the agreement closer to both the OECD model and the U.S. model, which will bring significant benefits, particularly to multinational tech companies.

4. Capital Gains – Article 13

Consistent with the treatment of dividends, interest and royalties, the protocol generally exempts any tax on capital gains, when realized upon the alienation of personal property located in one Contracting State, by a resident of the other Contracting State.

Under the current treaty, at source taxation is allowed upon the alienation of capital rights (stock, participations or other), if the recipient, during the 12 month period preceding the alienation, had direct or indirect participation of at least 25% of the capital in that legal entity. The protocol removes this paragraph, generally eliminating such tax. Consistent with the treaty, the protocol allows for taxation of gains derived from the sale of immovable property in the Contracting State in which such property is situated.

5. Limitation on Benefits – Article 17

Article 17 of the protocol, the LOB provision has gone through a comprehensive overhaul since the 1990 treaty. The treaty provides a basic LOB provision, but lacks much of the substance seen in more recent U.S. treaties. The new LOB updates the publicly traded test, the ownership-base erosion test, and the active trade or business test. In addition, the update adds new tests including a derivative benefits test, a headquarters company test, and a triangular branch rule.

Dual tax treaties are designed to act as a vehicle for providing benefits only to residents of the Contracting States.To further their purpose, tax authorities may take steps to prevent abuse of such treaties and treaty shopping. Although not found in early treaties, LOB provisions have been developed in an effort to ensure that only residents of the two Contracting States receive the benefits of the treaty. To this end, in order to enjoy the benefits conferred by the treaty, an individual or company must satisfy sufficient requirements to be classified as a qualified person ("Q.P.") under the treaty.

The LOB provision of the protocol will grant Q.P. status to a company that is able to satisfy one of the following tests, discussed below:

Publicly traded test; (Art. 17(2)(c))

Ownership-base erosion test; (Art. 17(2)(e))

Derivative benefits test; (Art. 17(3))

Active trade or business test; (Art. 17(4))

Headquarters company test; (Art. 17(5)) or

Competent authority test; (Art. 17(7).

Additionally, the protocol incorporates a triangular provision (Art. 17(6)) to address certain income that is attributable to a permanent establishment in a third country.

5.1. Publicly Traded Test

The publicly traded test will be the most familiar provision for large, publicly traded companies. Generally, a company will be considered a Q.P. if its principal class of shares is traded on a recognized stock exchange[7], and either that exchange is located in the Contracting State of which the company is a

[7]"The term 'recognized stock exchange' means: (i) the NASDAQ System and any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; (ii) any Spanish stock exchange controlled by the "ComisiónNacional del Mercado de Valores"; (iii) the principal stock exchanges of Stuttgart, Hamburg, Dusseldorf, Frankfurt, Berlin, Hannover, Munich, London, Amsterdam, Milan, Budapest, Lisbon, Toronto, Mexico City and Buenos Aires; and (iv) any other stock exchange agreed upon by the competent authorities." Article 17(8)(a), Protocol.

resident, or the company's primary place of management and control[8] is in the Contracting State of which it is a resident.

Under the 1990 treaty, the test was met if the company's principal class of shares was regularly traded on a recognized exchange. As an example of the more restrictive side of the new LOB, in conformity with the US model, the protocol implements an additional presence requirement. As previously mentioned, under the new LOB, the company must have a substantial connection to the Contracting State of which it is a resident, based on either the stock exchange it is listed on, or the place of management (in case of the company being listed on an exchange outside of the geographic scope).The test may also be satisfied if at least 50% of the aggregate vote and value of shares in the company is owned, directly or indirectly, by five or fewer companies that are themselves Q.P.'s.

5.2. Ownership-Base Erosion Test

The ownership-base erosion test, found in paragraph 2(e) provides an additional basis for a legal entity that is a resident of a Contracting State to qualify for benefits. The test is comprised of two parts, the ownership prong and the base erosion prong. Both must be satisfied in order for the company to qualify for treaty benefits. Although the test was found in a more basic form in the 1990 treaty, it has been substantially updated and closely mimics the 2006 U.S. Model, as well as many recent U.S. treaties[9].

The ownership prong can be satisfied if, on at least one half of the days of the taxable year, persons who are residents of a Contracting State, that are entitled to benefits of the treaty[10], own (directly or indirectly), shares which represent at least 50% of the aggregate voting power and value of the entity. In the case of indirect ownership, each intermediate owner must be a resident of that Contracting State. The test under the protocol is more stringent thanits predecessor in that it includes the requirement that the company receiving the income be owned by persons in the same Contracting State.

[8] "[A] company's 'primary place of management and control' will be in the Contracting State of which it is a resident only if executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial and operational policy decision making for the company (including its direct and indirect subsidiaries, if any) in that Contracting State than in any other state and the staff of such persons conduct more of the day-to-day activities necessary for preparing and making those decisions in that Contracting State than in any other state;" Art. 17(8)(d), Protocol.

[9] *See* U.S. & Poland (2013), available at http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Poland-2-13-2013.pdf and U.S. & Hungary (2010), available at http://www.treasury.gov/resource-center/tax-policy/treaties/Documents/Treaty-Hungary-2-4-2010.pdf.

[10] Such persons must be "entitled to the benefits of this Convention under subparagraph (a), subparagraph (b), clause (i) of subparagraph (c), or subparagraph (d) of this paragraph.." Art. 17(2)(e)(i), Protocol.

The second requirement, the base erosion test, is satisfied if less than 50% of the entity's gross income for the taxable year (as determined by the laws of the state of residence), is paid or accrued to persons who are not residents of either Contracting State entitled to benefits as defined by the ownership test, in the form of payments deductible in the company's state of residence. In conformity with the U.S. model, arm's length payments made in the ordinary course of business for services or tangible property are not included in the calculation. Going a step beyond the U.S. model, the protocol also excludes payments in respect of financial obligations to a bank, so long as the bank is not related to the payor.

5.3. Derivative Benefits Test

The derivative benefits test, new to the protocol, is similar to the previously discussed ownership-base erosion test and has an analogous two-part test.

The first component is met if 95% of the aggregate voting power and value of the company's shares is owned by seven or fewer persons that are equivalent beneficiaries[11]. Should the ownership be indirect, each intermediate owner must be a resident of a member state of the European Union, or any party to the North American Free Trade Agreement ("NAFTA"). The residency requirement makes the protocol's incarnation of the derivative benefits test even more analogous to the ownership-base erosion test.

The base-erosion requirement is met if less than one half of a company's gross income for the taxable year is paid or accrued, directly or indirectly, to persons who are not equivalent beneficiaries, in the form of deductible payments.

5.4. Active Trade or Business Test

The active trade or business test provides relief for particular items of income, if the income is derived in one Contracting State by a resident of the other Contracting State. To qualify for relief, the income must be derived in connection with or incidental to the resident's active trade or business. Although more defined, the substance of the test closely resembles the test of the treaty.

[11] "Equivalent beneficiaries" are those who are residents of an EU member state, or a party to NAFTA. Art. 17(8)(g), Protocol.

5.5. Headquarters Company Test

Also new to the LOB under the protocol is the headquarters company test (“HQ test”). The HQ test provides that a resident company of one of the Contracting States will be entitled to treaty benefits if that company functions as a recognized headquarters company for a multinational corporate group. A company will be considered a headquarters company if it meets all seven of the required criteria. These criteria include:

i) the company provides a substantial portion of the overall supervision and administration of the group;

ii) the corporation is engaged in business in at least five countries, and each activity generates at least 10% of the gross income of the group;

iii) the activities carried out in any one country other than the Contracting State of residence generates less than 50% of the gross income of the group;

iv) no more than 25% of its gross income is derived from the other Contracting State;

v) the company has, and exercises, independent discretionary authority to carry out the overall supervision and administration of the group;

vi) the company is subject to the same income taxation rules in its State of residence as those companies which fall under the active trade or business test; and

vii) the income derived in the other Contracting State either is derived in connection with, or is incidental to, the active business referred to in ii).

Although new to the 2013 Protocol, the HQ test is not revolutionary to U.S. bilateral treaties; it can also be found in the 1996 US-Switzerland dual tax treaty. While the provision requires all seven elements to be met, making it reasonably restrictive, it does provide an additional ground to gain treaty protection.

5.6. Approval by Competent Authority

Not substantially altered, the LOB provision continues to provide a catch-all by enabling the competent authority[12] of the Contracting State to grant treaty rights to residents of the other Contracting State, when appropriate.

Paragraph 7 provides that if a resident of one Contracting State is not a Q.P. pursuant to paragraph 2, or entitled to benefits under paragraphs 3, 4, or 5, the competent authority of the other Contracting State may grant benefits to the resident of the first Contracting State, "if such grant of benefits is justified based on an evaluation of the extent to which such resident satisfies the requirements of paragraphs 2, 3, 4 or 5 of this Article..."

Although the competent authority has broad discretion[13], by delineating such evaluation in light of the requirements of paragraphs 2, 3, 4 or 5, the article ensures that "persons that establish operations in one of the States with a principal purpose of obtaining the benefits of the Convention ordinarily will not be granted relief."[14] The article helps to promote the substance-over-form principle, by examining the true purpose, not the commercial form of the enterprise.

5.7. Triangular Rule

The revamped LOB also includes a triangular provision which aims to address the situation in which a resident of a Contracting State derives incomes from the other Contract State through a permanent establishment in a third country.

The provision calls for denial of benefits, if under such a situation, the combined aggregate effective tax rate in the state of residence and the third state is less than 60% of the general rate of tax applicable in the state of residence, if the income were attributed to that state, as opposed to the third state. In the case of dividends, interest or royalties, if the 60% threshold is not met, rather than denying all benefits, the provision calls for a withholding tax not to exceed 15% of gross. Further, there is an

[12]The competent authority in the case of the United State is the secretary of the Treasury or his delegate; in the case of Spain the competent authority is the Minister of Economy and Finance or his authorized representative. Art. 3(1)(i), Treaty.

[13]United States Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006, Pg. 73.

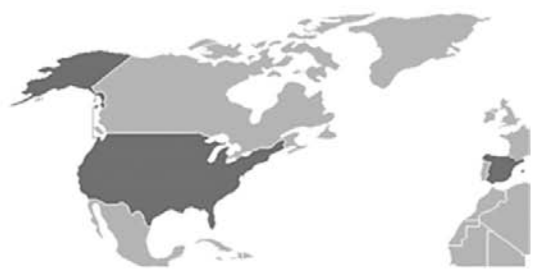
[14] Technical Explanation of the Convention Between the United States of America and the Swiss Confederation for the Avoidance of Double Taxation with Respect to Taxes on Income, Signed at Washington on October 2, 1996: 72

exemption in the case of royalties from the use of intangible property produced or developed by the permanent establishment itself.

Conclusion

By reducing dividend withholding, eliminating the withholding with respect to interest payments, eliminating the withholding in respect to royalty payments and eliminating at source taxation on the disposition of shares, the new protocol will help promote investment between the U.S. and Spain and put U.S. investment on a better footing as compared to other EU investors. Given the more favorable regime created by the reduced barriers, the incentives for treaty abuse and or treat shopping will be increased. For this reason, it is likely that more focus will be given to the amended LOB and its increasingly important role in preventing such abuses.

Before becoming effective, the protocol must follow the internal ratification procedures in the U.S. and Spain. Once ratified by both countries, the protocol will enter into force three months after mutual notice of ratification is given. However, given that there are other protocols waiting to be ratified, some even dating back to 2010, it may be some time before the protocol goes into force.



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