Baker McKenzie.

Alert | Tax

Spain, July 2019

Ever-closer to entry into force of the Protocol amending the Treaty between Spain and the United States to avoid international double taxation

On 16 July 2019, the United States Senate gave the green light to approving the Protocol (hereinafter "the Protocol") amending the Treaty between Spain and the United States on the avoidance of double taxation and the prevention of tax evasion, of 22 February 1990 (hereinafter "the Treaty").

This is undoubtedly a key milestone on the long road to ratification in order to promote investment and improve cross-border trade between the two countries.

1. Background

On January 14, 2013, Spain and the United States signed the Protocol, as well as a Memorandum of Understanding. Notes on error rectifications in the Protocol and the Memorandum were subsequently exchanged (23 July 2013 and 31 January 2014).

Since then, each Contracting State has had to follow an internal procedure until final ratification. In the case of Spain, in 2014, both the Congress and the Senate authorized the Government to consent to these texts without making any kind of amendment to them. In the United States, however, domestic procedure had been stalled in the Senate.

It is now for the President of the United States to sign the instrument of ratification and for both countries to notify each other through diplomatic channels that the internal procedure to be bound has been completed.

2. Date of entry into force

Article XV of the Protocol states that entry into force will take place **three months after the notification through the diplomatic channels** referred to above.

The provisions of the Protocol will take **effect**:

(a) for taxes withheld at source, on amounts paid or due, from and including the date of entry into force of the Protocol;

(b) for taxes calculated by reference to a tax period, for tax periods beginning on or after the date on which the Protocol enters into force;

(c) in relation to the provisions contained in the Protocol for the Mutual Agreement Procedure, these will only take effect in those cases submitted to the competent authorities from the date of entry into force of the protocol and once the implementing procedure has been approved in writing.

(d) in all other cases, from and including the date on which the Protocol enters into force.

3. Content

The following is a summary of the main developments under the new Protocol:

3.1 **Dividends**

The rate of withholding tax on dividends paid by a company resident in one Contracting State to a natural or legal person resident in the other Contracting State is reduced or even eliminated under certain circumstances, provided that the person receiving the dividends is the beneficial owner of them.

In this respect:

- The generally applicable tax rate is 15%.
- The **reduced tax rate** will be 5% (currently 10%) if the beneficial owner of the dividends is a company that directly owns at least 10% (currently 25%) of the voting shares of the company paying the dividends.
- **A new zero taxation rate** is introduced if the beneficial owner is a resident company that has held, directly or indirectly, through one or more residents of either Contracting State, shares representing 80% or more of the voting stock of the company paying the dividends, for a period of 12 months ending on the date on which entitlement to the dividends is determined and there is compliance with certain sections of the limitation on benefits clause in Article 17 of the Treaty itself.

  Without a doubt, this is one of the most significant changes, which is especially important for multinational groups with controlled subsidiaries.

  In addition, the existence of a new zero taxation rate will be important, not only for direct investment in Spain from the United States, but also for cases of indirect investment through a European holding company. In fact, it is likely that new direct holding structures will be put in place in the future.

In addition, new specific rules applicable to SOCIMIS, U.S. REITS, and Collective Investment Institutions are established, as well as a general exception to the obligation to withhold on dividends received by pension funds.

3.2 **Branch tax**

In order to equate the taxation applicable to profits obtained through subsidiaries and branches, profits distributed by branches or permanent establishments to their headquarters will not be subject to withholding, provided that certain clauses of limitation of benefits contained in Article 17 of the Treaty are complied with.

If these are not met, the withholding will be 5% (currently, such distribution of benefits is subject to a withholding rate of 10%).

3.3 **Interest:**

In general, interest paid to a person resident in the other Contracting State who is the beneficial owner of such interest **will not be subject to withholding**.

However, an **anti-abuse clause has been** established for the case of certain interest paid from the United States to persons resident in Spain, such as the so-called "**contingent interest**" which cannot be considered a portfolio interest under United States internal regulations. These contingent interests are generally those that are referenced or determined on the basis of sales volumes, cash flows, profits, increases in the value of assets, dividends or similar parameters of the debtor or of entities related to it.

The justification for this exception lies in trying to prevent payments in the form of interest, the economic substance of which more closely resembles a share in profits, from falling outside U.S. taxation. While the logical consequence would have been to subject this interest to the general dividend withholding rate of 15%, as this is not same taxation treatment (since it only applies to interest paid by residents in the United States), in the negotiations Spain managed to reduce this rate to 10%, which is the same as the rate contemplated for interest by the current Treaty.

3.4 Royalties

There will be no taxation at source on royalties paid from one Contracting State to another provided that the recipient of such royalties is the beneficial owner of the income.

This change is particularly significant given that the current wording of the Treaty, which establishes three different types of withholding depending on the type of intangible whose right of use is assigned, has always led to disputes due to the different interpretations that taxpayers and the Tax Administration make of the type of royalty.

This measure is especially relevant for certain business sectors, such as the technological or pharmaceutical sectors.

3.5 Capital gains

One of the most important changes provided for in the Protocol is the amendment to Article 13 of the Treaty on the taxation of capital gains.

The current wording of the Treaty, which allows profits from the disposal of shares, holdings or other rights in the capital of a company to be taxed in the Contracting State of source, has been deleted, provided that the recipient of the capital gain has, during the twelve months prior to the transfer, a direct or indirect holding of at least 25% of the capital of that company. To date, this regulation has had a very negative impact on the corporate restructuring of large multinationals, since many of the reorganisations involving a transfer of shares into one company by another company resident in the other state, even within a group, determined the obligation to pay taxes, which has led to a slowdown on this type of transactions.

Taxation is kept in place on capital gains obtained by a person resident in a Contracting State for the transfer of shares of companies with assets consisting mainly of real estate located in the other Contracting State, while, on the contrary, taxation in the source Contracting State is eliminated in other cases.

3.6 Transparent entities

Fiscally transparent entities will generally be able to benefit from the Treaty when: (i) the income is attributed to a resident of one of the Contracting States; (ii) no exception to those contained in the article on Limitation on Benefits is applicable; and (iii) the entity that is considered fiscally transparent is constituted or organized in the United States, Spain or any other state that has an agreement containing provisions for the exchange of information with the Contracting State from which the income originates.

In this regard, the new wording modifies the 2006 Mutual Agreement between the United States and Spain on the treatment of LLCs, S corporations and other partnerships or entities not subject to US corporate income tax, and limits the possibility of applying the Treaty in the case of transparent entities that are resident in a territory with which the source Contracting State has not signed an agreement for the exchange of information.

Therefore, the Treaty will not apply to vehicles that are transparent from a US perspective but resident in a jurisdiction that has not signed an exchange of information agreement with Spain.

3.7 Limitation on benefits clause

In order to apply the benefits of the Treaty, a test is established that requires both direct holders and intermediate holders (in the case of indirect participation) to be resident in a European Union member state or party to the North American Free Trade Agreement.

In addition, this clause includes a test for corporate headquarters of multinationals and a specific regulation for cases of triangular operations through branches. The following should be noted in this regard:

- For listed companies (which in principle automatically benefit from the Treaty), application is extended to listed companies not only on the US or Spanish stock exchanges, but also other stock markets such as London, Frankfurt, Amsterdam, Toronto, Mexico City or Buenos Aires.
- This is the first time that the United States has included a restriction on the residence of intermediate holders in a limitation on benefits clause.
- For the test relating to the corporate headquarters of multinational groups, under certain conditions, entities that act as headquarters for multinational corporate groups (entities that, among other requirements, provide a substantial part of the general supervision and administration of the group) may benefit from the Treaty. This clause was expressly requested by Spain in order to prevent foreign-securities holding entities or "ETVEs" with non-EU shareholders from being excluded from the application of the Agreement.
- The specific regulation for triangular operations through the use of branches excludes those incomes obtained through permanent establishments located in third countries from the application of the Treaty when those incomes are subject to effective reduced rates of tax (i.e., rates lower than 60% of the general corporate tax rate applicable to the head office).

Finally, the competent authority of a Contracting State is allowed to grant the benefits of the Treaty on a discretionary basis, even if not all the requirements of the limitation on benefits clause itself are met. However, the discretion of individual states to grant benefits under the Treaty is much more limited than in other agreements signed by the United States, in that it requires consideration of the other Contracting State's view of the suitability of granting such benefits.

3.8 Mutual Agreement Procedure

As a new development, the new Protocol provides for a binding arbitration procedure to be followed in the event that the competent authorities have not been able to resolve a case within two years and provided that the competent authorities agree that the case is suitable for resolution by arbitration.

Particularly noteworthy is the introduction of the so-called "*baseball clause*", by virtue of which the arbitrator may only choose between one of the positions presented by each Contracting State, which in practice will prevent Contracting States from making the maximal proposal in an attempt to have their proposal chosen by the arbitrator. In addition, in order to avoid arbitration precedents, the arbitral decision need not be reasoned.

Finally, it should be noted that the arbitration panel decision is binding for the Contracting States, except if the taxpayer does not accept such decision. Therefore, the taxpayer will have the possibility of rejecting the decision reached by the arbitration panel.

3.9 **Permanent establishment**

The general definition of permanent establishment in Article 5 of the Treaty remains unchanged.

However, the Protocol introduces an amendment which is particularly relevant for companies in the construction sector by extending the minimum period for construction, installation or assembly works to constitute a permanent establishment from 6 to 12 months.

3.10 **Puerto Rico**

The United States and Spain have signed a Memorandum of Understanding in which they undertake to initiate talks to adopt measures to avoid double taxation on investments between Spain and Puerto Rico.

3.11 **Other changes**

The Protocol also provides for important amendments to different aspects of the Treaty, such as non-discrimination, exchange of information and administrative assistance. The Protocol also provides for specific regulation of pensions and REITs.

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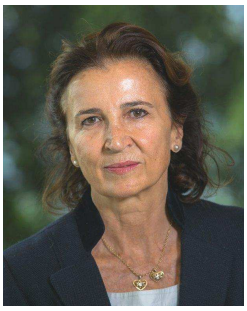
If you have any questions or require any further explanation, please do not hesitate to contact us.

Yours sincerely,

Baker McKenzie

More information:



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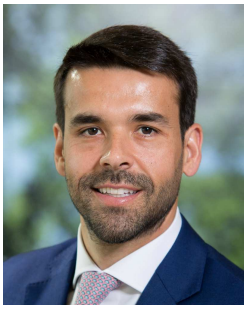

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