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International Tax

United States Tax Alert

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Protocol signed with Spain to amend existing income tax treaty

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On January 14, 2013, the US and Spain signed a protocol ("proposed protocol" or "2013 protocol") that would amend the existing income tax treaty and protocol ("1990 treaty" and "1990 protocol"). If and when the proposed protocol is ratified and enters into force, the US-Spain treaty will be much more similar than it is now to US treaties with other major EU member states. Thus, the amended treaty would require each country to reduce its current tax in many cases on the interest, royalty, and direct investment dividend income of residents of the other country; the revised Article 17 (Limitation on Benefits) of the amended treaty ("LOB" provision) would allow for "derivative benefits" and limit benefits in the case of income earned through third-country permanent establishments (PEs). The amended treaty also would force the competent authorities into binding arbitration to resolve future cases that they can't settle on their own.

This alert outlines some of the key features of the proposed protocol as we understand them at this initial public stage in the process of moving the protocol toward entry into force. To the extent that provisions of the proposed protocol raise questions, developments between now and ratification may well answer them. For example, the US Treasury Department most likely will issue a Technical Explanation (TE) at the time of the Senate Foreign Relations Committee hearing that will be held before the proposed protocol is ratified by the US. The upcoming TE may provide significant additional guidance on some of the provisions of the proposed protocol.

Effective date provisions

The proposed protocol will take effect only if it is ratified by both contracting states. It will enter into force three months after each country has notified the other that its ratification procedures have been completed. For withholding taxes, the 2013 protocol will apply to dividends, interest and royalties paid or credited on or after the date the protocol enters into force. For taxes determined by reference to a taxable period, it will be effective for taxable periods beginning on or after such date.

Reduced withholding tax rates on dividends, interest and royalties

Direct investment dividends – The proposed protocol generally would reduce the withholding tax rate on dividends to 5%, from the current rates of 10% or 15%, where the beneficial owner of the dividends is a company that owns directly at least 10% of the voting stock of the company paying the dividends. The treaty currently reduces the rate to at best 10%, and then only for dividends from 25%-owned companies.[1]

The proposed protocol would eliminate withholding tax on a narrower class of intercompany dividends, and dividends paid to pension funds.[2] For intercompany dividends, the exemption would apply only if (a) the beneficial owner of the dividends is a company that has owned, directly *or indirectly through one or more residents of the US or Spain,* at least 80% of the voting stock of the company paying the dividends for the full 12-month period ending on the date on which entitlement to the dividends is determined; and (b) the beneficial owner of the dividends qualifies for treaty benefits under one of three specified provisions, or combination of provisions, of the LOB article,[3] or qualifies for benefits pursuant to a competent authority determination.[4]

Interest – Interest generally would be exempt from source country

[1] The top rate on dividends, under both present law and the proposed protocol, generally is 15%. The proposed protocol, like the 1990 protocol, contains special rules for dividends paid by a regulated investment company (RIC), a real estate investment trust (REIT), and certain Spanish entities. The proposed version of some of these special rules differs from the ones in the 1990 protocol, and in the case of REIT dividends, follows those found in more recent US income tax treaties and the US model treaty.

[2] The pension funds to which the exemption applies are those described in Article II of the proposed protocol and paragraph 3 of the accompanying Memorandum of Understanding (MOU).

[3] The provisions specified are the publicly traded/subsidiary of a publicly traded company test, ownership/base erosion test and active trade or business test, and derivative benefits test.

[4] Consistent with the rates on dividends, the branch profits tax generally is imposed at a maximum rate of 5%, and is eliminated if the company satisfies one of the specified LOB provisions (or combination of provisions) referred to above or is granted discretionary benefits by the competent authority.

taxation under the proposed protocol; this would represent the general elimination of the 10% tax permitted by the existing treaty. A 10% US tax would remain applicable to US source interest that does not qualify as "portfolio interest" under US law because it is contingent on, e.g., the issuer's profits.[5]

Royalties – Royalties generally would be exempt from source country taxation, eliminating the taxes of 5% to 10% permitted by the existing treaty.[6]

Income earned through fiscally transparent entities

Following the pattern of other post-2001 US tax treaty provisions, the proposed protocol replaces paragraph 5(b) of the 1990 protocol—which treats a partnership as a resident of a contracting state only to the extent the income it derives is subject to tax in that state as the income of a resident—with a provision similar to Article 1(6) of the US model addressing income derived through an entity that is fiscally transparent under the laws of either treaty country. However, the proposed protocol differs from its predecessors in that it distinguishes among entities by place of formation or organization.

If the fiscally transparent entity is formed or organized in the US or Spain, income derived through the entity would be considered to be derived by a resident of a contracting state to the extent the item is treated as income of a resident under the laws of such state. If the fiscally transparent entity is formed or organized in a third country, this look-through rule would apply only if that third country has an exchange of information agreement with the contracting state from which the income is derived. Thus, income derived by a Spanish resident through a reverse hybrid (treated as a flow-through entity for Spanish tax purposes and a corporation for US tax purposes) would not be eligible for treaty protection from US tax if the reverse hybrid were formed or organized in a country that does not have an information exchange agreement with the US.

Capital gains

The proposed protocol would delete paragraph 4 of Article 13

[5] This is less than the 15% rate on such interest provided in numerous other US treaties and the US model treaty.

[6] Unlike the definition in the US model, the proposed protocol's definition of "royalties" does not include gains derived from the alienation of intangible property contingent on the productivity, use or disposition of that property. Also, as amended, the treaty would no longer define "royalties" as explicitly including payments for technical assistance associated with intangible property. Since the amended treaty would not permit source country taxation of such income unless attributable to a PE, the absence of these definitions would not appear to be material.

(Capital Gains) of the treaty, which permits a contracting state to tax a resident of the other state on gains from the alienation of stock, participations or other rights in the capital of a company or other legal person resident in the first state if the recipient of the gain had a direct or indirect participation of at least 25% in the capital of that company or other legal person. Although the US generally does not tax non-FIRPTA,[7] non-effectively connected US stock gains of nonresident aliens and foreign corporations, this provision currently allows Spain to tax Spanish stock gains of US residents. Under Spanish legislation, the sale of stock in a Spanish company by a non-resident investor is generally taxable with some exceptions (e.g., gains on the sale of stock traded on an exchange where the transferor is resident in a treaty country).

The proposed protocol would add a new treaty Article 13(4) that would permit taxation by a contracting state of gains from the alienation of shares or other rights that "directly or indirectly entitle the owner of such shares or rights to the enjoyment of immovable property," i.e. real property, situated in that contracting state. At first glance this provision appears to broadly permit source country taxation on the disposition by a nonresident of real estate-related shares or other ownership rights, regardless of the residence of the issuer.

The US does not generally tax the disposition of stock by a nonresident (unless the stock is issued by a US company and it has not been established that the company was never a "U.S. real property holding corporation" in the last five years of the alienator's holding period), and Article 13(1) of the treaty (which the proposed protocol would not change) generally permits US taxation of nonresidents' stock, partnership interest, and other gains in cases where FIRPTA imposes such tax. Thus, the effect of the proposed new Article 13(4) may be to allow Spain to tax the gains on the disposition of an interest in an entity by a US resident where a portion of the gain is attributable to immovable property located in Spain. Since Article 13(2) of the treaty already allows Spain to tax gains from the sale of stock of a company or other legal person "the property of which consists, directly or indirectly, *mainly* of real property situated in Spain," it may be that the new provision is intended to apply to shares in entities with immovable property in Spain, below this threshold, or other indirect interests in Spanish immovable property.

Limitation on benefits

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[7] "FIRPTA" stands for "Foreign Investment in Real Property Tax Act of 1980."

The proposed protocol would modernize the treaty's LOB article and make it generally more consistent with the US model and recent US income tax treaties with other EU member states. As a result, the proposed protocol would revise the requirements of the existing treaty's publicly traded test, subsidiary of a publicly traded company test, ownership/base erosion test and active trade or business test. The protocol also would add a derivative benefits provision and a headquarters company test, as well as a triangular rule addressing third country PEs.

Like most US treaties' subsidiary of a publicly traded company tests, and more recent treaties' ownership/base erosion tests, each test in the proposed protocol permits intermediate owners, with restrictions. Unlike the existing treaty with Spain, the subsidiary of a publicly traded company test would allow indirect ownership, but any intermediate entities would have to be a resident of the US or Spain. To qualify under the ownership/base erosion test under the proposed LOB provision, and unlike the existing treaty, a resident of a contracting state would have to be at least 50%-owned, directly or indirectly, by a specified type of resident of *the same* state. In the case of indirect ownership, and again unlike the existing treaty, any intermediate owner would also have to be a resident of that state.

The derivative benefits requirements in the proposed protocol are similar to the requirements in recent US treaties with other EU member states, including a 95% direct or indirect ownership requirement by seven or fewer equivalent beneficiaries, and a base erosion requirement. Uniquely, in the case of indirect ownership, the derivative benefits provision in the proposed protocol would require each intermediate owner to be a resident of an EU or NAFTA country. This new requirement for intermediate owners might indicate a change in US treaty policy. It is also noteworthy that neither Swiss residence, nor residence in a member state of the European Economic Area that is not also an EU member state, could lead to equivalent beneficiary status under the proposed protocol.

The proposed protocol's version of the "active trade or business test" generally tracks the one in the US model. The proposed test is more comprehensive than that in the existing treaty in dealing explicitly with certain technical questions. For example, the proposed protocol provides that a related person's trade or business activities would be taken into account in determining whether the test is satisfied. In addition, the proposed protocol sets forth the requirement applicable in certain cases that activity in the residence country would have to be “substantial in relation to the trade or business activity carried on by such resident or related person in the other Contracting State.” However, in line with the US model treaty, the proposed protocol does not include a substantiality safe harbor, instead providing that substantiality “will be determined based on all the facts and circumstances.”

Other provisions

The protocol would add a mandatory binding arbitration provision for mutual agreement procedure cases that the competent authorities are unable to resolve within two years. Currently, there are four US tax treaties (Belgium, Germany, Canada and France) with an arbitration provision, and the pending protocol with Switzerland also contains such a provision. Unlike some of the recent treaty arbitration provisions, the provision in the proposed protocol is not proposed to apply to cases that the competent authorities are already considering before the protocol enters into force.

In connection with Article 5 (Permanent Establishment) of the treaty, the proposed protocol would extend the safe harbor for a building site, construction project, installation project or drilling rig from six months in the existing treaty to 12 months. It does not appear that the proposed protocol would adopt the “Authorised OECD Approach” (or AOA) for determining the profits attributable to a PE.[8]

Conclusion

The amendments that would be made by the proposed protocol warrant a review of existing structures. In the future, US income of Spanish residents, and Spanish income of US residents, may be considerably more treaty-protected from source-country tax than is currently the case. Also, new LOB provisions may make it easier for a Spanish or US resident to qualify for treaty benefits (for example, due to the inclusion of a “derivative benefits” provision in the LOB article).

On the other hand, some proposed LOB provisions are potentially more restrictive than current law. As discussed above, the proposed LOB article could preclude a resident from qualifying for treaty benefits under the ownership/base erosion test by virtue of its owners in the other treaty country, or indirect owners where the intermediate owners do not satisfy certain requirements. Also, under the proposed protocol, income derived through a fiscally transparent

[8] See OECD 2010 Report on the Attribution of Profits to Permanent Establishments, July 22, 2010.

entity formed or organized in a third country would be considered derived by a resident of a contracting state only if the third country has a tax information exchange agreement with the source state.

Taxpayers whose existing or potential future structures may be affected by the changes that the proposed protocol would make should begin thinking about these effects, and follow carefully the upcoming events that will lead to their entry into force, listening for any clarifications (e.g. in the TE of the proposed protocol) that emerge in the process.
