

US Senate ratifies Spain-US tax treaty protocol

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Executive summary

On 16 July 2019, the United States (US) Senate ratified the protocol amending the US tax treaty with Spain (the Protocol). The Protocol, signed on 14 January 2013, includes a number of updates to the current Spain-US Treaty, including:

- ▶ Withholding rate of 0% on certain dividend payments
- ▶ General exemption from withholding tax on cross-border interest, royalties and capital gains
- ▶ New fiscally transparent entity rules
- ▶ New comprehensive Limitation on Benefits provision
- ▶ Mandatory binding arbitration procedures
- ▶ Revised exchange of information provisions

There are still a number of procedural steps the US must complete before the Protocol may enter into force, a process that is coordinated with the US Department of State. In particular, the instruments of ratification must be drafted by the State Department and then transmitted to the President for his signature.

Detailed discussion

Elimination of taxation on capital gains

One of the most salient amendments of the Protocol is the revised Article 13 on capital gains tax.

The current 1990 treaty allows the State of source to impose tax on capital gains derived from the transfer of shares where the recipient of the gain, during the 12-month period preceding the transfer, had participation, directly or indirectly, of at least 25% in the capital of that company. In addition, Spain could also tax capital gains on the transfer of land rich entities.

The revised wording of Article 13 maintains the capital gains tax on the transfer of land rich entities, but eliminates it in all other cases.

Reduction or elimination of withholding tax on dividends, interest and royalty payments

Under the Protocol, dividend distributions will be exempt from withholding taxes when they are derived from qualifying participations (representing a minimum 80% in the voting rights of the distributing entity held for a 12-month period, and provided certain specific provisions under the limitation on benefits clause are satisfied).

Dividends from non-qualifying participations will benefit from a reduced 5% or 15% withholding tax:

- ▶ 5% of the gross amount of the dividend if the beneficial owner of the dividend is a company resident in the other State that owns directly shares representing at least 10% of the voting power of the company paying the dividend.
- ▶ 15% of the gross amount of the dividend in the rest of the cases.

Also, no withholding tax will generally apply to interest and royalty payments made by Spanish or US companies to residents in the other State, provided that the recipient of the income is the beneficial owner.

Branch tax

The treaty currently in force imposes a 10% additional branch tax on the remittance of profits by branches to their head offices. The Protocol retains the provision authorizing the branch profits tax but it specifically subjects such tax to the rate imposed on dividends.

Permanent establishment

The general definition of permanent establishment currently in force is maintained but the Protocol extends the minimum threshold for a building site or construction or installation project to constitute a permanent establishment from 6 to 12 months.

Transparent entities

Substituting the rules currently applicable, under the new provision, an item of income derived through an entity that is fiscally transparent under the laws of either the US or Spain, and that is formed or organized (a) in either the US or Spain or (b) in a State with a tax information exchange agreement in force with the Contracting State from which the income is derived, will be considered to be derived by a resident of the US or Spain (as the case may be) to the extent that the item is treated for purposes of the taxation law of the US or Spain (as the case may be) as the income of a resident.

Article 1 of the Memorandum of Understanding clarifies that in order to obtain the benefits of the Spain-US tax treaty, with respect to an item of income, profit or gain derived through a fiscally transparent entity, the person deriving the item of income must satisfy all applicable requirements of Article 1 (General Scope), residence as defined in Article 4 (Residence), beneficial ownership and Article 17 (Limitation on Benefits).

Mutual agreement procedure (binding arbitration)

The Spanish Protocol provides for mandatory and binding arbitration and incorporates a number of provisions regarding procedural aspects of the arbitration process.

New LOB Provision

The Protocol also contains a comprehensive LOB provision that is similar to those of other US treaties and protocols, as well as with the 2006 US Model Treaty. Generally, the LOB article provides that a treaty-resident company will be eligible for benefits under the Spain-US tax treaty only if it satisfies one of the following tests:

- ▶ The publicly traded company (or subsidiary of a publicly traded company) test
- ▶ The ownership-base erosion test
- ▶ The active trade or business test
- ▶ The derivative benefits test
- ▶ The headquarters company test
- ▶ A competent authority determination

Other amendments

The Protocol also includes revisions to other provisions of the existing treaty, including, but not limited to, the LOB, Non-Discrimination provisions and introduces special provisions governing pension funds and real estate investment companies.

Moreover, the Protocol has also updated the exchange of information provisions to conform to the 2006 US Model Treaty and to the standards developed by the Organisation for Economic Co-operation and Development.

Entry into force

The approval procedure has been completed in Spain, pending approval in the US.

There are still a number of procedural steps the US must complete before the Protocol may enter into force.

The Protocol will enter into force three months following the date when the US and Spain have notified each other that all internal procedures for entry into force have been complied with.

Thus, once the US has completed the necessary steps described above, it is expected that notification and the exchange of the instruments of ratification could take place fairly quickly.

Once the Protocol enters into force, its provisions will generally have effect (i) with respect to withholding taxes, for amounts paid or credited on or after the date on which the Protocol enters into force; (ii) for taxes determined by reference to a taxable period, for tax years beginning on or after the date on which the Protocol enters into force; and (iii) in all other cases, on or after the date on which the Protocol enters into force.

Implications

The amendments of the Protocol include long-time requested changes to the existing Spain-US income tax treaty.

The new capital gains exemption upon the transfer of shares is of particular interest. This exemption favors corporate restructurings that to date are generally too costly taxwise.

Changes to the dividend article in the Protocol will make distributions more tax efficient.

The exemption from withholding tax on interest in the Protocol is now in line with those in several other US treaties with European Union countries and will be welcomed by taxpayers.

Also, the mandatory arbitration provisions are anticipated to facilitate more efficient settlement of disputes. The updated exchange of information provisions are expected to provide the tax authorities with the data they need to more effectively audit Spanish and US taxpayers.

Taxpayers should carefully review the Protocol, and the entry into force provisions, to determine whether and to what extent they are affected by these new developments, as well as the effective dates of the new provisions.

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