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US Senate finally passes new protocol to the Spain-US Double Tax Convention

Legal Flash Tax

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- **The ratification of the new protocol, signed in 2013, but blocked in the US Senate until July 16 this year, has been completed.**
- **The new protocol amends the double tax convention signed between Spain and the United States. Among other changes, it reduces withholding taxes on dividends, interest and royalties, provides no taxation at source for capital gains on the transfer of qualified shares, modifies the limitation-on-benefits clause and includes arbitration within the mutual agreement procedure.**
- **The new Protocol will be effective once diplomatic formalities are completed.**

In 2013, Spain and the US signed a protocol ("2013 Protocol") modifying their double tax convention signed in 1990 ("**DTC**"). However, its approval could not be completed due to a general block affecting US tax treaties since 2011. This paralysis was the result of certain concerns about the new exchange of information regime to be included in the Protocol.

After more than six years, the procedures required in the US Senate for the ratification of the 2013 Protocol have been completed. Amendments to the tax treaties signed by the US with Luxembourg, Switzerland and Japan will be unblocked as well.

This 2013 Protocol, accompained by a brief memorandum of understanding ("**MoU**"), modifies aspects of the DTC and its protocol. Two different protocols coexist: the one originally approved with the DTC, and the new Protocol recently approved.

We highlight below the main amendments included in the new Protocol and the expected time frame for these changes.

Changes included in the 2013 Protocol

Scope of the DTC

The 2013 Protocol includes specific language for tax transparent entities in line with the Mutual Agreement signed in 2006: if a member of a transparent entity (incorporated in Spain, the US or a third state with exchange of information) is taxed by its state of residence on the income earned through the entity, this income is considered obtained by a resident of the state for DTC purposes.

It defines pension fund. From a Spanish standpoint, a pension fund is any entity operated mainly to manage the right of its beneficiaries to receive income or capital on retirement, survivorship, widowhood, orphanhood, or disability, to the extent contributions to it are deductible from the taxable base of personal taxes. The MoU refers to three cases covered under Spanish law.

Permanent establishments (PE)

The new Protocol covers the branch profits tax. Under article 19.2 of the Spanish Non-Residents Income Tax, this tax (*imposición complementaria*) is imposed on amounts resulting from PEs of foreign entities that are transferred abroad.

The previous regulation (article 14 of the DTC, now deleted) established a 10% tax, which drops to 5% under the new Protocol (paragraphs 8 and 9 of article 10 of the DTC). Also, exceptions linked to the specific circumstances of the limitation-on-benefits ("**LOB**")clause prevent the application of this tax.

On a separate note, the definition of PE relating to building sites or construction is now linked to a 12-month period (as in the OECD Model Tax Convention), as opposed to the former 6-month period.

Dividends

Under the amendments included in the new Protocol, article 10 of the DTC establishes the following withholding rates applicable to dividends when the beneficial owner is a resident of the other contracting state:

- 15% general rate under the DTC. US shareholders or members of a Spanish REIT or fund can benefit from this reduced rate if their participation does not exceed 10% of the entity's share capital.
- 5% if the beneficial owner is a company holding direcly at least 10% of the voting stock. This does not apply to dividends paid out by a Spanish REIT.
- No withholding tax applies if the beneficial owner has directly or indirectly held, through entities resident in Spain or the US, shares representing at least 80% of the voting stock during the previous 12 months and certain circumstances included in the LOB clause are met.
- No withholding tax applies if the beneficial owner is a pension fund exempt from tax at a 0% rate and dividends do not result from a trade or business carried out by the pension fund or through an associated entity. Dividends paid out by a Spanish REIT can only benefit if the interest in the REIT does not exceed 10% of its share capital.

The Protocol eliminates the characterization of liquidation proceeds as dividends.

Interest

Under the new Protocol, article 11 of the DTC establishes a rule of exclusive taxation in the state of residence, i.e., withholding taxes on interest are abolished when the beneficial owner is resident in the other contracting state.

This is an important difference from the previous version of the DTC, where a 10% maximum withholding rate applied, with certain exceptions. The new Protocol maintains a couple of exceptions that can lead to taxation of certain US-sourced interest in the US.

Royalties

Royalties are also no longer subject to withholding taxes in the source state if the beneficial owner is resident in the other contrating state. In line with the principle of exclusive taxation at the residence state, article 12 of the DTC no longer mentions the state where the PE to which those royalties are connected as the source state of the royalties.

The 2013 Protocol has eliminated from the definition of royalties any reference to payments for technical assistance related to the application of any right or property covered by this concept and for the use of, or the right to use, industrial, commercial, or scientific equipment. It has also eliminated the characterization as royalties of gains arising from the alienation of these rights or properties, to the extent that these gains are contingent on their productivity, use or nature.

Capital gains

The source state can no longer tax capital gains arising from the transfer of shares representing at least 25% of the capital of a company. In turn, that state will have taxing rights over capital gains arising from the alienation of shares that directly or indirectly entitle the owner of those shares or rights to benefit from immovable property .

Therefore, under the new Protocol, the source state will only be able to tax capital gains obtained on the direct transfer of real estate, on the transfer of shares in companies whose main assets are real estate in that state or entitle the owner to the rights discussed above, or on the transfer of assets attributable to a PE.

Pensions

When an individual is a participant or a beneficiary of a pension fund resident in the other contracting state, the new Protocol prevents the individual's residence state from taxing that individual unless the pension fund makes any distribution.

Limitation-on-benefits clause

The DTC benefits can only be applied by residents of the contracting states covered by one of the categories established in the LOB clause, which has new wording under the 2013 Protocol.
This is a complex clause that restricts access to the DTC in specific, objective circumstances (it is not a general anti-abuse rule) that should be analyzed case by case.

Arbitration in the mutual agreement procedure

Under the new Protocol, if the mutual agreement procedure has elapsed for two years and the authorities have not been able to solve the case, it will be solved in an arbitration procedure, which is binding on the contracting states.

There may be some limitations, e.g., if the authorities agree that the case is not suitable for arbitration, or the requirement that a decision relating to the case has not already been rendered by a court or administrative tribunal of either contracting state.

The inclusion of arbitration in the mutual agreement procedure will ease the dispute resolution of matters linked to the DTC. Currently, Spain's tax treaty network only provides for arbitration in the conventions with Switzerland and the United Kingdom, although implementation of the multilateral instrument (MLI) will increase the list.

New exchange of information regime

The new Protocol establishes a new regime for exchange of information and administrative assistance, which is more developed that the regime in the original version of the DTC. For example, it broadens the scope of the exchange of information to include taxes not covered by the DTC.

Entry into force and effects

The changes included in the new Protocol come into effect three months after diplomatic procedures have finished, which may be in 2019. They will apply as follows:

- For taxes withheld at source (e.g., dividends, interest and royalties), the changes are effective from the date the Protocol enters into force.
- For taxes determined with reference to a taxable period (e.g., income attributable to a PE), the changes are effective for taxable periods beginning on or after the date the Protocol enters into force.
- In all other cases (e.g., exchange of information or arbitration), the changes are effective from the date the Protocol enters into force.

Regarding the effects on the mutual agreement procedure and arbitration, these changes will not affect cases that have already been submitted to the authorities on the date the Protocol enters into force. For other cases, the authorities need to agree on the applicable procedure for the arbitration.

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