Spanish Tax Alert

GÓMEZ-ACEBO & POMBO

THE NEW PROTOCOL AMENDING THE TAX TREATY BETWEEN THE UNITED STATES OF AMERICA AND THE KINGDOM OF SPAIN.

Javier Vinuesa
Tax Law Department, Gómez-Acebo & Pombo Law Firm

Last 14 January 2013, the Protocol (hereinafter referred to as the "**new Protocol**") amending the Convention between the United States of America and the Kingdom of Spain (hereinafter referred to as the "**US**", "**Spain**" or collectively as the "**Contracting States"**) for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income (hereinafter referred to as the "**Tax Treaty**") was signed in Madrid.

The ratification process will now start in both countries, however, it is always complex to predict when this process will be completed (the ratification process of the existing Tax Treaty took ten months in 1990) and, hence, when these modifications will enter into force and have effects.

According to the officials of both States, the new Protocol is intended to bring the Tax Treaty currently in force into closer conformity with the current tax treaty policies of both countries. In a nutshell, the new Protocol provides for exclusive residence-country taxation of interests, royalties and certain direct dividends and capital gains. In addition, the term to have a permanent establishment for building sites or construction or installation projects will be extended from six to twelve months.

The purpose of this document is to outline the main changes introduced by the new Protocol, mainly in connection with the taxation of Spanish source income and to provide a preliminary analysis on some of the issues that the new Protocol may arise from the Spanish tax perspective. For ease of reference, we have tried to follow the same numbering of the Tax Treaty.

- ***Fiscally transparent entities***

  Following the United States Model Income Tax Convention (2006) (hereinafter referred to as the "**US Model**"), the new Protocol includes within the scope of the Tax Treaty fiscally transparent entities provided that the income earned by the entity is taxed as income of a resident. However, the scope is also extended to fiscally transparent entities organized in a third country that has an agreement in force with Spain or the US containing a provision for the exchange of information on tax matters.

By way of an example, a European Economic Interest Grouping formed in the UK with a Spanish member deriving US source income may be entitled to the Tax Treaty benefits in respect to the income taxed in the hands of the Spanish tax resident.

- ***Pension Funds***

The new Protocol also provides a definition of pension funds in both Contracting States. A more detailed definition has also been included in the Memorandum of Understanding (hereinafter referred to as the "**MOU**") accompanying the new Protocol.

Surprisingly, according to the Spanish definition, qualifying as a pension fund requires that the contributions to that pension fund should be deductible from the taxable base of the Spanish Individual Income Tax.

However, according to Spanish domestic tax regulations, the deductible amount of contributions to a Spanish pension fund is limited to a certain amount. The question that arises from that definition is if a Spanish pension fund receiving contributions over those limits would be entitled to the Tax Treaty benefits.

- ***Definition of any term not defined in the Tax Treaty***

The rules introduced by the new Protocol in order to characterize any term not defined in the Tax Treaty follow the OECD Model Tax Convention on Income and Capital (hereinafter referred to as the "**OECD Model**") and, hence, first refer to the meaning granted to this term by the laws of that State concerning the taxes to which this Convention applies (see Article 2 of the Tax Treaty).

- ***Permanent establishment***

The new Protocol makes three changes in Paragraph 3 of Article 5 (Permanent establishment).

First, a drafting precision is introduced adding "or the exploration activity". The purpose of this amendment is to confirm that the duration term also applies to an installation or drilling rig or ship used for the exploration of natural resources. Further to that change, the article now reads exactly as Paragraph 3 of Article 5 of the US Model.

Second, in accordance with both the US and the OECD Models, the duration term has been extended from six to twelve months.

And third, but not least, the end of Paragraph 3 of Article 5, whereby "*for the purpose of computing the time limits in this paragraph, activities carried on by an enterprise associated with another enterprise within the meaning of Article 9 (Associated enterprises) shall be regarded as carried on by the last-mentioned enterprise if the activities of both enterprises are substantially the same, unless they are carried on simultaneously"* has been deleted.

The deletion of this paragraph raises a number of doubts as the rule computing the time spent in connected projects is included in the Official Commentaries on Article 5 of the OECD Model and the US Technical Explanations accompanying the US Model (hereinafter referred to as the "**US Technical Explanations**").

As a matter of fact, according to the US Technical Explanations:

> "(…) *these interpretations of the Article are based on the Commentary to paragraph 3 of Article 5 of the OECD Model, which contains language that is substantially the same as that in the Convention."*

Consequently, this anti-abuse rule shall continue to apply, regardless of the deletion of the last paragraph.

- ***Dividends and Branch Profits Tax***

The new taxation of dividends could be summarized as follows:

✓ **15%** taxation if the participation held in the voting stock of the company paying the dividends is lower than 10%.

✓ **5%** taxation if the direct participation held is at least 10%.

✓ **0%** taxation if the participation held represents 80% or more of the voting stock of the company and the participation has been held during at least 12 months provided that the Limitation on Benefits clause of Article 17 is satisfied.

✓ **0%** for dividends distributed to pension funds (See definition above)

The branch profits tax levied on profits distributed by permanent establishments is limited to **5%**.

Likewise, according to the new Protocol (See Article XIV), Spanish source dividends distributed by a Spanish REIT "*Sociedad Anónima Cotizada de Inversión en el Mercado Inmobiliario"* (hereinafter referred to as "**SOCIMI**") would be taxed in Spain at the following rates:

✓ **15%** if the direct or indirect participation held does not represent more than 10% of all the capital in the SOCIMI.

✓ **0%** if the dividend is distributed by the SOCIMI to a qualifying pension fund provided that the direct or indirect participation held does not represent more than 10% of all the capital in the SOCIMI.

Finally, Spanish source dividends distributed by a Spanish investment institution "*Instituciones de Inversión Colectiva*", among others, mutual funds, investment companies (SICAVs), or real estate funds or investment companies would be taxed in Spain at the following rates:

✓ **0%** if the dividend is distributed by the Spanish investment institution to a qualifying pension fund.

✓ **15%** in all other cases

As in the former Tax Treaty, in order to benefit from these Tax Treaty rates, the recipient of the dividend must be the beneficial owner. The new guidance on the beneficial ownership concept in the frame of Articles 10, 11 and 12 of the OECD Model will then be applicable.

- ***Interests***

  As a general rule, Spanish source interests will only be taxed in the US. The residence taxation would also apply for US source interests with some exceptions for some US source contingent interests that do not qualify as portfolio interest under US Law.

  Again, the beneficial ownership condition has been maintained.

  This new interest taxation will avoid the use by US residents of third countries' entities to invest in Spain.

- ***Royalties***

  The residence country taxation can be retained as the general rule provided that recipient is the beneficial owner of the income.

  This new taxation will eliminate a number of controversies that the former wording of this Article had generated in connection with the application of some of the reduced Tax Treaty rates.

- ***Capital gains***

  The new Protocol has kept Paragraph 2 of Article 13 whereby gains from the alienation of stock, participations, or other rights in a company or other legal person the property of which consists, directly or indirectly, mainly of real property situated in Spain, may be taxed in Spain.

  However, a new provision (paragraph 4) has been included according to which capital gains made on the disposal of shares or other rights which directly or indirectly entitle the owner of the shares to the enjoyment of immovable property may be taxed in the country where the property is located.

  This provision does not follow the Article 13 of neither the US Model nor the OECD Model. Contrary to the OECD Model, this rule actually allows the Contracting State in which the property is located to tax that gain, even if less than 50% of the value of the shares is attributable to the immovable property, provided that the shares acquired grant the shareholder the right to use that property.

  Although the wording of this provision may be misleading and trigger the Spanish taxation of any capital gain made upon the disposal of shares of companies that have the right to the enjoyment of immovable property located in Spain (under Spanish Law, a lease contract will grant such right), we understand that in order to apply this provision, the use of the property should be effectively and directly granted to the owner of the shares, in other words, if the owner of the shares can not enjoy the property owned by the entity whose shares or rights are sold, that provision would not apply. Time sharing schemes whereby the acquisition of a security will grant the right to use an immovable property in a Contracting State may fall within the scope of this provision.

  Finally, the capital gains made on the disposal of shares of non real-estate Spanish companies will be taxable in the US only. The former substantial participation clause has been eliminated.

- ***Limitation of Benefits clause***

  The new Protocol contains a comprehensive limitation on benefits provision that is intended to ensure that only residents of the United States and Spain will enjoy the benefits of the Tax Treaty.

  A significant number of provisions of the Tax Treaty are conditioned to the fulfillment of this clause.

- ***Arbitration Proceeding***

  Consistent with a number of recent U.S. tax treaties, the mutual agreement procedures that the authorities of both Contracting States are unable to resolve during two years shall be resolved through a mandatory binding arbitration provision.

  This arbitration proceeding will not have retroactive effects for cases started before the entry into force of the new Protocol.

- ***Exchange of Information and Administrative Assistance***

  The new Protocol also provides for the full exchange of information between the competent authorities to facilitate the administration of each country's tax laws and the collection of taxes.

- ***Puerto Rico***

  During 2013, negotiations for the signature of a Tax Treaty with Puerto Rico will start.