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New Protocol amending the current U.S. - Spain Tax Treaty

16 September 2019

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On 14 January 2013 the U.S. and Spain signed a new protocol (the "**Protocol**") **amending the current 1990 tax treaty** for the avoidance of double taxation in force between the two countries (the "**Treaty**"). After being blocked for more than six years, the U.S. Senate finally ratified the Protocol on 16 July. The President of the U.S. signed the Protocol on 5 August.
The Protocol will enter into force on 27 November and will significantly alter the tax treatment of payments made between the U.S. and Spain.

The Protocol includes significant changes to foster the efficiency of reciprocal direct investment in the U.S. and Spain. Specifically, it brings treaty withholding rates and other provisions into line with the tax treaties in force between the U.S. and the main European Union Member States.

In most cases, the Protocol eliminates taxation at source, creating significant savings and increasing net yields:

i. **On dividends, a 0% withholding rate applies to corporate shareholders controlling 80% of the voting stock,** under specific conditions (a 5% rate applies for holdings of 10% or more).

ii. **Interest and royalty payments will no longer be subject to withholding taxes** (limited exceptions apply in connection with certain U.S. source interest).

iii. **Capital gains will only be taxed at source on the disposal of real estate and real estate holding companies** (subject to certain requirements).

The Protocol also reinforces technical mechanisms to avoid double taxation through **Mutual Agreement Procedures** ("**MAPs**") and provides for **arbitration** to resolve tax issues. The Treaty's **exchange-of-information clause is updated** to current standards for this type of clause.

Also of interest is the **new wording of the Limitation of Benefits** (the "**LoB**") clause, which is very detailed and includes favourable exceptions such as the "headquarters company", along with the regulation of fiscally transparent entities and funds. The application of the LoB clause must be carefully analysed by U.S. investors holding interests in Spain.

The principal terms of the Protocol are summarised below.

1. DIVIDENDS

The Protocol leads to a significant reduction of taxation at source, as the Treaty provides for a 10% withholding tax when the company receiving the dividend controls 25% of the voting rights, and 15% in other cases.

According to the Protocol, withholding tax rates on dividends are:

i. 0% if the beneficial owner is a company that directly or indirectly owns shares representing more than 80% of the voting stock, such shareholder has held the shares in the distributing company for a minimum period of 12 months prior to the distribution, and meets the conditions of the so-called reinforced LoB clause;

ii. 5% if the beneficial owner of the dividends is a company that owns 10% or more of the voting stock; and

iii. 15% in all other cases.

Specific regulations apply to Spanish SOCIMIs and U.S. REITs, and certain tax exemptions apply to distributions to pension funds. It is expected that the reduction in the dividend withholding tax rate will boost direct investments between the U.S. and Spain, in particular for multinational groups.

2. INTEREST

In general, taxation at source is eliminated and, thus, no withholding taxes will apply to interest payments earned by beneficial owners of the interest received. Specific rules apply for U.S. source contingent interest and loans related to U.S. real estate mortgage conduits (REMICs).

The new provisions represent a significant change given that U.S. regulated financial entities (that are corporations not acting through Spanish permanent establishments) should be fully exempt from withholding taxes on interest paid by Spanish borrowers, regardless of the term of the loan. This will increase the competitiveness of U.S. financial entities in the Spanish market.

3. ROYALTIES

Taxation at source is eliminated (except for permanent establishments) for beneficial owners of such income and, thus, no withholding taxes will apply to royalty payments.

The measure is expected to be widely applauded by IT companies, pharmaceutical groups, multinational manufacturing companies in Spain, and others. The Protocol's entry into force will eliminate current withholding taxes ranging from 5 to 10% and will put an end to several disputes with the Spanish tax authorities.

4. CAPITAL GAINS

The Protocol significantly alters the approach to the sourcing and taxation of capital gains.

No taxation at source will apply to capital gains, except upon

i. the disposal of assets or rights associated with a permanent establishment in Spain; or

ii. the disposal of real estate assets or shares in companies holding real estate assets, time-share rights, or shares or rights which directly or indirectly entitle the owner to the enjoyment of Spanish properties (which, in Spain, would be subject to a 19% capital gains tax).

Furthermore, gains deriving from the transfer of licences and intangible property should qualify as capital gains (and not as royalties), therefore being exempt from taxation at source.

5. BRANCH TAX

Article 14 of the Treaty, on the right to impose a 10% branch tax, will be eliminated. However, under article 10 of the Treaty, as amended by the Protocol, U.S. taxation of the "dividend equivalent amount" and the imposition of Spanish branch tax (up to a maximum rate of 5%) will be permitted in circumstances similar to those applicable to dividends (including a 0% rate when the reinforced LoB clause's conditions are met).

6. LIMITATION OF BENEFITS

The Protocol provides for a significantly amended LoB clause. The wording of the new clause covers numerous situations in detail and should be carefully analysed on a case-by-case basis. Among others, the following features are worth noting:

(i) the traded-company exception, by virtue of which a listed company automatically benefits from the Treaty, will now apply to companies listed not only in the U.S. or Spanish stock exchanges, but also on "recognised stock exchanges" such as those of London, Frankfurt, Amsterdam, Toronto, Mexico City and Buenos Aires. However, a thorough analysis should be carried out when dealing with the reinforced LoB conditions applicable to, for example, the 0% rate on dividends;

(ii) the inclusion of a "headquarters company exemption", affording the Protocol's protection and benefits to entities qualifying as headquarters for multinational groups (i.e. those providing overall supervision for at least five jurisdictions, amongst other requirements); or

(iii) a "permanent establishment triangular clause" for anti-abuse purposes, excluding permanent establishments located in third countries from the benefits of the Treaty and the Protocol if the permanent establishment is taxed at a reduced rate (i.e. less than 60% of the general tax applicable to the parent company).

7. PENSION FUNDS

Under the Protocol, dividends paid to a pension fund resident in the other contracting state will not be subject to source taxation provided that the recipient is exempt from tax or subject to a 0% tax rate and the dividends distributed do not derive from the carrying out of a trade business activity by the pension fund or through an associated enterprise of the pension fund.

In addition, the Protocol allows for the possibility of rolling the investment over to pension funds of the other contracting state (i.e. cross-border roll over) without triggering taxation, as taxation will be contingent upon effective payment or distribution to the beneficiaries.

8. SPANISH SOCIMIS AND U.S. REITS

The general 5% reduced tax rate introduced by the Protocol does not apply to dividends distributed by Spanish SOCIMIs, U.S. RICs and REITs. However, the reduced 15% rate (0% rate for pension funds) may be applicable to

(i) dividends distributed by a Spanish SOCIMI to beneficial owners (including pension funds) that own no more than 10% of the voting stock of a SOCIMI; and

(ii) dividends distributed by a U.S. REIT to beneficial owners that (a) are individuals or pension funds which own no more than 10% of the voting stock of the REIT; (b) own no more than 5% of the voting stock of the REIT, when the dividends derive from listed shares; or (c) own no more than 10% of the voting stock of a “diversified” REIT.

9. MUTUAL AGREEMENT PROCEDURE AND ARBITRATION

Disputes regarding the interpretation of the Treaty and the Protocol will be resolved through MAPs.

In addition, the Protocol provides for mandatory arbitration to resolve matters submitted to a competent authority. Regulation of the arbitration procedure is extensive and detailed. The decision of the three-member arbitration panel will be, with certain exceptions, binding.

10. EXCHANGE OF INFORMATION

The exchange-of-information clause is updated to comply with current standards. No express reference is made to the future implementation of FATCA provisions. It is important to note that Spain and the U.S. have implemented FATCA through domestic reporting and reciprocal automatic exchange of information, also based on the Treaty.

11. PUERTO RICO

A Memorandum of Understanding (“**MOU**”) has also been signed by the U.S. and Spain indicating that specific measures to avoid double taxation on investments between Spain and Puerto Rico will be adopted in the future.

12. FISCALLY TRANSPARENT ENTITIES

The Protocol and MOU slightly amend the 2006 Competent Authority Agreement entered into by the U.S. and Spain on the tax treatment of LLCs, partnerships and disregarded entities. Income obtained through fiscally transparent entities will benefit from the provisions of the Treaty and the Protocol, provided that (i) the income is allocated to a resident (as defined in the Treaty) for the purposes of its taxation in accordance with domestic provisions; (ii) the LoB exclusions do not apply; and (iii) the fiscally transparent entity is organised under the laws of the U.S. or Spain, or those of a state that has entered into an agreement for the exchange of tax information with the specific country.

It should be noted that the 2006 Competent Authority Agreement did not include the restriction in point (iii) above, so careful analysis should be undertaken with respect to existing structures that include the use of fiscally transparent entities holding Spanish investments, when such entities are organised in jurisdictions such as the Cayman Islands, a tax-haven territory for Spanish tax purposes.

13. THE PROTOCOL'S ENTRY INTO FORCE

The Protocol will enter into force on 27 November 2019.

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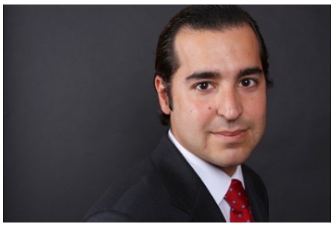

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