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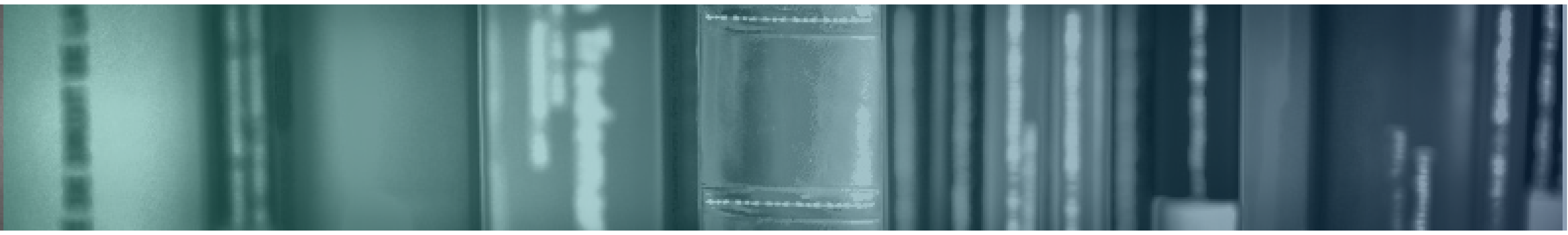

NEW DOUBLE TAXATION TREATY BETWEEN SPAIN AND JAPAN

On 16 October 2018, Spain and Japan signed a new tax treaty in connection with income taxes and to prevent tax evasion and avoidance, as well as its Protocol (the "**Treaty**"). After complying with the many formalities in both countries, the Treaty will apply from 1 May 2021.

The Treaty will significantly change how payments between Spain and Japan are taxed as it introduces major changes to the former treaty, which dated back to 1974, and will result in elimination or reduction of taxation in the source county.

The new Treaty includes the OECD and G-20's recommendations from Project BEPS and is in line with the 2017 OECD Model Tax Convention and the new international standards deriving from the so-called Multilateral Instrument.

As a result, the new Treaty introduces anti-abuse rules and establishes a favourable legal framework to promote investment and commercial and economic transactions between both countries, so that taxation does not restrict business development.

In this regard, the Treaty's preamble expressly states that the purpose of the Treaty is to avoid double taxation in connection with income taxes, but without leading to non-taxation or reduced taxation opportunities through tax evasion or avoidance (including seeking the most favourable treaty to indirectly benefit third-State residents).

Also worth noting, because it is unique in relation to other treaties Spain has signed, the Treaty introduces a limitation-on-benefits clause (known as the LOB clause) under which some benefits are limited to persons that meet certain criteria. The Treaty also includes a general anti-abuse clause (the Principal Purpose Test or PPT rule) and two specific anti-abuse clauses, one against three-way transactions with permanent establishments and another for cases of taxation on a remittance basis.

Before analysing the changes in the Treaty, it is important to highlight that its scope is limited to income taxes (i.e. corporate income tax, personal income tax and non-residents income tax) and, unlike other tax treaties, it does not deal with wealth taxation.

We set out the main changes below.

1. TRANSPARENT ENTITIES

The first article of the Treaty introduces a new section to regulate how income obtained by totally or partially transparent entities is to be treated for tax purposes.

2. REAL ESTATE INCOME

According to the Treaty, real estate income can be taxed in the State in which the properties are located. The new Treaty updates the concept of real estate income and extends it to encompass income obtained from using or exercising rights of use over real estate.

3. DIVIDENDS

The Treaty considerably reduces taxation at source. The former treaty established a 10% withholding if the beneficiary of the dividend was a company that directly held at least 25% of the share capital with voting rights, and a 15% withholding in all other cases.

According to the Treaty, the following withholding rates apply:

i) 0% in the following cases:

  a) the beneficial owner of the dividend is a company that has directly or indirectly held at least 10% of the voting rights in the company paying out the dividend for 12 months; or

  b) it is a "well-known pension fund".

This benefit does not apply if the company receiving the dividend is excluded because the LOB clause analysed in section 9 below applies.

ii) 5% in all other cases.

Notwithstanding this, the Treaty includes a clause for cases of hybrid asymmetries, according to which a 10% withholding applies if the dividend is deductible when the taxable income of the company paying out the dividend is calculated.

However, the Treaty restricts the application of these reduced withholding rates as follows: the recipient of the dividend must be its "beneficial owner". In this regard, in accordance with the commentaries on the OECD Model Tax Convention, those who are merely used to "channel" the dividends to other persons are not "beneficial owners".

These measures will undoubtedly encourage investment between Spain and Japan, in particular for multinational groups.

4. INTEREST

Another important change in the Treaty is that, in general, interest payments cease to be subject to withholding tax (whereas under the former treaty a 10% withholding rate applied), which facilitates financing between Japanese and Spanish companies. In the same way as with dividends, the new Treaty states that the recipient of the interest must be its "beneficial owner".

Again, this benefit does not apply if the LOB clause applies to the recipient company.

However, the Treaty establishes a 10% withholding rate on interest that is calculated with reference to revenue, sales, income, benefits or other property income generated by the debtor or a related person, as could be the case with profit participating loans.

5. ROYALTIES

The Treaty has also removed withholding tax on royalties. The Treaty clarifies, again, that the "beneficial owner" must receive the royalties.

The 10% withholding tax established in the former treaty therefore ceases to apply, which will undoubtedly facilitate the transfer of patents and trademarks, as well as designs, formulas and other industrial, commercial and scientific experience between companies in both countries and, in particular, between companies of the same multinational group.

Again, this benefit does not apply if the LOB clause applies to the company receiving the royalties.

6. CAPITAL GAINS

The Treaty updates the taxation of capital gains derived indirectly from the transfer of real estate, in line with the new OECD Model Tax Convention.

Any capital gains obtained by a resident of a signatory State of the Treaty after transferring shares or other types of shareholdings in a company, as well as shareholdings in partnerships or trusts, can be taxed in the other signatory State if, at any time within the 365 days preceding the transfer, over 50% of the value of the shares or shareholdings derives directly or indirectly from real estate. Capital gains derived from transfers of rights that directly or indirectly entitle their owner to use the real estate may also be taxed.

Conversely, the Treaty includes a specific provision for individuals who face the so called exit tax on unrealised gains following a change of residence. In these cases, the other signatory State will carry out the corresponding adjustment over the capital gains obtained when the properties are transferred to avoid double taxation, if needed.

7. ENTERTAINERS AND SPORTSPERSONS

The "entertainers and sportspersons" clause clarifies that, if the income generated by entertainment or sporting activities is allocated to a company, it does not need to be linked to or controlled by the entertainer or sportsperson in question for it to be taxed in the place where the activity is carried out.

8. PASSIVE INVESTMENT ARRANGEMENT (*TOKUMEI KUMIAI*)

The Treaty includes a new provision under which income obtained as a result of a (*Tokumei Kumiai*) by a passive investor resident in Spain can be taxed under Japanese regulations, if the income comes from Japan and is deductible when the taxpayer's taxable income in Japan is calculated.

9. LIMITATION ON BENEFITS CLAUSE (LOB CLAUSE)

The Treaty introduces the LOB clause according to which benefits under the Treaty do not apply to certain income, such as dividends, interest and royalties, unless the recipient of that income is considered a qualified person (i.e. one that meets the required conditions) under the terms of article 28 of the Treaty, or in the cases specifically set out in that provision, such as entities that play an active role in the economic activity of the other State and the income derives from that economic activity or is supplementary to it, entities in which persons who are considered “equivalent beneficiaries” directly or indirectly own at least 75% of the share capital, or headquarters of multinational groups.

In this regard, multinational groups must be especially careful with holding entities, entities that carry out management and financing activities for the group (including cash pooling), and entities that manage investments or hold or manage intangible assets, as these economic activities are not exempt from the application of the LOB clause unless they meet the requirements to be considered a qualified person.

10. MUTUAL AGREEMENT PROCEDURE AND ARBITRATION

The Treaty also reinforces the procedures available to avoid double taxation through the Mutual Agreement Procedures (“**MAPs**”) and provides for the possibility of resorting to arbitration if the competent authorities in both States are unable to reach an agreement.

In this regard, the Treaty (article 7 – “business profits”) states that, if a related-party transaction gives rise to an adjustment, the other State must make the corresponding adjustment and, if necessary, the competent authorities of both States may liaise with each other to determine that adjustment.

11. EXCHANGE OF INFORMATION AND ASSISTANCE IN THE COLLECTION OF TAXES

The Treaty amends the exchange-of-information clause in accordance with current standards and includes a new provision on assisting with tax collection. The scope of this co-operation in the collecting of taxes is not limited to income tax – to which the Treaty applies generally – but also encompasses other taxes such as VAT, inheritance and gift tax, or wealth tax in the case of Spain.

12. ENTRY INTO FORCE AND APPLICATION OF THE TREATY

Although, according to the Protocol, the Treaty is expected to enter into force on 1 May 2021, most of the Treaty’s major changes will be effective as from 1 January 2022.

In relation to taxes levied that depend on the tax year, the Treaty will apply to tax periods initiated after 1 January 2022. Conversely, the Treaty will apply from 1 January 2022 to taxes levied that do not depend on the tax year.

The exchange-of-information and tax-collection provisions will enter into force on 1 May 2021.

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