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News Alert

Tax Department

Entry into force of Amendments to the Double Taxation Convention between Spain and the United States.

On 27 November 2019, the Protocol¹ introducing important amendments to the Agreement to Avoid Double Taxation signed between Spain and the United States enters into force, (hereinafter, “DTA”). The following are the amendments which, in general terms, we consider to be the most relevant.

In addition, a comparative version of the DTA text can be viewed at the [following link](#):

I. Entry into force and Application

In accordance with Article XV of the Protocol, the new withholding tax rates apply to income paid or accrued as of 27 November.

Where taxation relates to a tax period, the amendments shall be applied to tax periods beginning after that date.

In all other cases, the new Protocol applies from the date of entry into force.

The amendments made to the Mutual Agreement Procedures will not apply to procedures initiated before the entry into force of the new Protocol.

II. New Withholding Rates

The most important amendments would be the overall reduction in the withholding rates applicable to non-resident income, without permanent establishment (PE).

¹ Protocol amending the Agreement between the Kingdom of Spain and the United States of America for the Avoidance of Double Taxation and the Prevention of Tax Evasion in respect of Income Taxes, and its Protocol, signed in Madrid on 22 February 1990 (BOE (Boletín Oficial del Estado [Official Spanish Gazette]) of 23 October 2019, No. 255)

Income	Current	New
Dividends (Art. 10)	10% - 15%	<u>0%</u> (direct or indirect) shareholding of 80% of the shares with voting stock for a period of 12 months and consideration as a qualified person - Art. 17-) <u>5%</u> (shareholding of at least 10% of the shares with voting stock). <u>15%</u> (all other cases). Special pension fund rules.
Interests (Art. 11)	10% (general rule)	<u>0%</u> General Rule Anti-abuse rules for: (i) "contingent interest" in cases that does not qualify as portfolio interest, Section 871(h)(4) (ii) Real Estate Mortgage Investment Conduit (REMIC).
Royalties (Art.12)	5%/8%/10%	<u>0%</u>
Capital gains (non-real estate shares) Art. 13	19% (when "at any time" in the previous twelve months" the transferor held (sic) -directly or indirectly- at least 25% of the capital)	Not subject

As can be seen, the new Protocol introduces a significant reduction in the withholding tax rates applicable at source as compared to those previously applicable.

1. Dividends (Art. 10 of the DTA)

The withholding tax rates applicable to dividends are significantly lower than those currently in force. Thus:

- The maximum withholding tax rate is set at **15%**.
- Such **withholding rate is reduced to 5%** gross amount of the dividends when the beneficial owner is a company that owns **directly** at least 10% of the voting stock of the company paying the dividends.
- **Withholdings (0%)** on dividends distributed to parent **companies** that hold, **directly or indirectly** (if indirectly through US and/or Spanish residents), at least **80%** of the voting stock in the entity paying the dividends when the shares have been held for a minimum period of one year prior to the date on which the dividend becomes due and provided that the recipient of the dividends - in addition - is entitled to the benefits of the DTA, in accordance with the following articles:
 - ✓ 17.2.(c) for a publicly traded company (or publicly traded subsidiary).
 - ✓ 17.2.(e) when it additionally carries on a business under the terms of Article 17.4 of the DTA.
 - ✓ 17.3, this is the shareholders of the entity receiving the dividends are equivalent beneficiaries.

- ✓ 17.7, to the extent that the right to the benefits of the DTA had been recognised by the tax authorities of the source State.

Finally, dividends received by pension funds are declared exempt from withholding when they are exempt from taxation in their country of residence and such dividends do not correspond to the performance of a business activity of the pension fund.

Due to its special significance in relation to the regulatory amendments introduced by the *Tax Cuts and Jobs Act of 2017*, colloquially known as the “Trump Reform”, it should be noted that the DTA allows a Contracting State to impose a tax on the resident shareholders of foreign subsidiaries, to the extent that the latter do not “repatriate” profits.

The DTA establishes certain special rules in relation to dividends paid by the following companies:

- (a). Sociedades Anónimas Cotizadas de Inversión en el Mercado Inmobiliario (SOCIMI) [Publicly Traded Property Investment Companies]

Dividends paid by these companies to U.S. beneficiaries will be subject to the withholding established by Spanish law (19%) without being able to benefit from the benefits of the DTA. However, when the shareholding in SOCIMI is not higher than 10% of the capital, the withholding would increase to 15%.

Dividends paid by SOCIMIs to U.S. pension funds may benefit from the 0% rate (Article 10.4) when the beneficial owner's share is less than 10%.

- (b). Collective Spanish Investment Schemes Law 35/2003 (CIS)

Dividends paid by these entities to U.S. partners or shareholders may benefit from the 15% withholding rate. Furthermore, when the beneficial owner is a US pension fund (Article 10.4) the withholding rate would be 0%.

Apart from the above, neither SOCIMI nor CISs can benefit from the 5% or 0% withholding rates.

- (c). U.S. Regulated Investment Company (RIC)

Dividends paid by a RIC to Spanish beneficiaries may only benefit from the reduced rate of 15%.

When dividends are paid into a pension fund (Article 10.4) the withholding will be 0%.

- (d). U.S. Real Estate Investment Trust (REIT)

In the case of dividends paid by REIT to Spanish shareholders, the reduced withholding rate of 15% (0% in the case of pension funds) will be the only reduced rate that could be applied, provided that one of the following conditions is met:

- When the beneficial owner - individual or pension fund – holds not more than 10% of shareholding.
- The class of shares in respect of which dividends are paid is traded on the stock exchange and the beneficial owner has a holding not exceeding 5%.
- The participation in the REIT does not exceed 10% and the investments of the REIT are considered diversified according to the definition of the DTA.

2. Interests (Art. 11 of the DTA)

In general, interests paid by a resident of Spain or the United States to a beneficial owner of the other State will not be subject to withholding.

Two anti-abuse clauses are established in relation to two types of interest paid by U.S. entities: (i) “contingent interest” when it does not qualify as a financial investment under the U.S. standard, and (ii) “excess interest” corresponding to a *Real Estate Mortgage Investment*.

It should be noted that income from participating loans, are regarded as interest, implying that under the general rule of no taxation at source, US lenders (not acting through PEs located in Spain) will generally receive interest from Spanish borrowers without withholding.

3. Royalties (Art 12 of the DTA)

The new DTA eliminates the withholdings for the royalties so that compared to the DTA in force until now (which established a withholding of between 5 and 10%), from the entry into force of the DTA, the royalties paid by Spanish companies to actual profits in the USA will not be subject to withholding.

4. Capital gains (Art. 13 of the DTA)

After the entry into force of the new DTA, the general rule becomes the non-taxation in the State of source of the capital gains, except when they come from the sale of real properties or rights over them.

The taxation of shares is eliminated (excluding property companies).

5. Taxation on branches and property income– “Branch profit tax” (Art. 14 of the DTA)

In those cases in which a resident of one State does not operate in the other State through a Permanent Establishment or obtains property income (Arts. 6 and 13.1 of the DTA), they may bear a tax equivalent to that which would be borne by the distribution of a dividend if said income had been obtained through a company.

The tax rate will be equivalent to that which would bear a dividend, i.e. 5%, and may be 0% when the aforementioned conditions are met (see point 1.Dividends)

III. Limitation on Benefits (Art. 17 of the DTA)

One of the main amendments to the new Protocol is the establishment of a Limitation on Benefits clause.

According to Article 17 and unlike the text of the DTA in force until now, in order to apply the benefits of the DTA, it would not be enough to prove resident status in the United States or in Spain; since from 27 November onwards, in addition to residence, it will be necessary to prove that the recipient of the income has the status of “qualified person or entity” (or “eligible person” in OECD terminology).

The purpose of this clause is to deny the benefits of the DTA to structures that would normally permit the indirect application of those benefits and that would give access to those benefits to persons or entities that are not entitled to the direct application of those benefits, recognising however that in some cases persons who do not reside in the U.S. or Spain could establish an entity in those countries for legitimate commercial reasons.

The article is structured as follows:

- Paragraph 1 provides that a resident of both Spain and the USA would not be eligible for the benefits of the DTA unless he or she can be considered a qualified person.
- Paragraphs 2 and 3 establish who can be considered a “qualified person” in a subjective manner. These persons shall be eligible for the benefits of the DTA in relation to all their income [“subjective qualifications”].
- Paragraphs 4, 5 and 7 grant the benefits of the DTA in certain situations, although the benefits will only apply in respect of certain types of income [“objective qualifications”].
- Paragraph 6 deals with so-called “triangular” cases and refers to cases in which the Permanent Establishment (PE) of an enterprise in a third country participates in obtaining the income.
- Finally, Section 8 includes definitions of some of the concepts used in the rest of the article.

1. General Clause on Limitation on Benefits (Art. 17.1)

Article 17.1 of the DTA establishes that a “resident” of either the United States or Spain shall only be entitled to the benefits of the DTA if - in addition to being a resident - he has the status of a “qualified person” in a subjective or objective manner, in the terms of Article 17 itself.

The Limitation on Benefits clause does not preclude the possibility of a general anti-abuse clause in both Spanish and US domestic law, Article 17 being complementary to the domestic rule. The internal rule makes it possible to identify the “beneficial owner” of the transaction and Article 17 establishes whether the beneficial owner can benefit from the DTA.

2. Subjective Qualifications (Art 17.2 and Art 17.3)

The following persons or entities may benefit from the DTA for all the income they obtain regardless of the type of income:

- (a). Individuals resident either in Spain or in the U.S. as long as they do not act in a purely interposed manner (nominee)
- (b). States, their political subdivisions, local authorities and institutional agencies with full public ownership.

- (c). A company: (i) listed (in the terms of the DTA) whose principal place of management and control is located in the country where it is resident, either Spain or the USA. (ii) companies owned - directly or indirectly - by five or fewer of the publicly traded companies referred to in (i) above, when such holding reaches at least 50% of their shares and voting rights and provided that in the case of indirect ownership all the indirect owners are resident either in Spain or in the USA.
- (d). **Non-profit organisations, pension funds and American companies managing pension plans.** The DTA refers in the first place to entities whose constitution and existence are exclusively of a religious, charitable, scientific, artistic, cultural or educational nature. Secondly, to pension funds where **more than 50 per cent of their beneficiaries**, members or shareholders are natural persons **resident in any of the Contracting States**; and to management companies acting in favour of pension funds which in turn may benefit from the DTA because they are considered eligible or qualified persons.
- (e). **Subsidiaries of qualified persons or entities that do not deduct expenses that erode the taxable base.** The new text of the DTA recognises the status of qualified entity to those companies that simultaneously meet the following two requirements:
- (i). At least 50% of all the shares, voting rights and value of the company is owned - directly or indirectly - by persons or entities resident in the same State as the Company itself and that - in accordance with the above rules (exclusion made of rule c.(ii), subsidiaries of publicly traded companies) are considered a qualified person or entity provided that said shareholding has been maintained for half of the "tax year". In the case of indirect shareholdings, "all" indirect owners must be residents of the same State as the company itself.
 - (ii). The company does not deduct expenses or payments considered likely to erode the taxable base by an amount that reaches 50% of gross income. For these purposes, the following items are regarded as eroding taxable base.
 - Any interest payment, except payments made in respect of financial obligations to a bank not related to the payer.
 - Any payment to non-resident persons (both independent and/or related) provided that the recipients of such payments are not resident in Spain or the United States and do not have the subjective consideration of "qualified person" according to the DTA itself (exclusion made of rule c.(ii), subsidiaries of publicly traded companies). For these purposes, payments that respond to fully arms-length conditions related to the activity of providing services or delivering tangible goods of the company are excluded.

It should be noted that criterion (e) above will in most cases apply to subsidiaries of non-publicly traded companies, as such subsidiaries will normally obtain the classification under point c.(ii) which in most cases is easier to achieve.

(f). Qualification deriving from the classification of shareholders as “equivalent beneficiaries”. Depending on this criterion, companies resident in both the U.S. and Spain may apply the benefits of the DTA when they meet the following requirements:

(i). At least 95% of the total voting rights and the value of its shares (and at least 50% of any type of privileged shares giving entitlement to a disproportionate share of profits) belong - directly or indirectly - to seven (7) or fewer equivalent beneficiaries [as defined in Article 17.8 itself]. In the event of indirect shareholdings, “all” indirect owners must be residents of an EU Member State or a State party to the North American Free Trade Agreement.

(ii). The company does not deduct expenses or payments to persons or entities that **are not equivalent beneficiaries** and that are considered capable of eroding the taxable base by an amount that reaches 50% of gross income. For these purposes, they are considered to be “liable to erode the taxable base”:

- Any interest payment, except payments made in respect of financial obligations to a bank not related to the payer.
- Any payment to residents or non-residents/both independent and/or connected persons who are considered “non-equivalent beneficiaries”. For these purposes, arm’s length payments that respond to fully competitive conditions related to the activity of providing services or delivering tangible goods of the company are excluded.

Article 17.8 considers persons or entities resident in a Member State of the European Union or a State party to the North American Free Trade Agreement to be “equivalent beneficiaries” when that resident fulfils either of the following two conditions:

(i). Is a resident of either Spain or the U.S. and is considered a “qualified person” under Article 17.2 (a), (b), (c).i. and (d) of this DTA.

(ii). Meet the following two conditions:

1st. Would be entitled to benefit from all the benefits arising from an alternative DTA concluded between any EU Member State or party to NAFTA and the State party to the new Protocol to which the application of the benefits provided for in the DTA is claimed (either the US or Spain) and under such alternative DTA would be treated as a “qualified person” by virtue of provisions analogous to those provided for in Article 17.2 (a), (b), (c).i.,(d), of the DTA and, alternatively, if such DTA did not include a Limitation on Benefits clause similar to that of the DTA that person or entity, if they were resident in the US or Spain could be qualified as a “qualified person” under the rules of Article 17(2)(a), (b), (c).i.,(d).

2nd. And according to this alternative DTA, the tax payable on income obtained in Spain or in the USA. (insurance premiums, dividends, interest or royalties) is less than or equal to that resulting from the application of the DTA between Spain and the US.

3. Objective qualifications (arts. 17.4, 17.5 and 17.7)

Once the persons or entities that are considered to be subjectively qualified persons or entities and that are therefore going to be able to apply the benefits of the DTA in relation to all their income are determined, the DTA establishes a series of additional situations in which residents of both Contracting States (USA and Spain) are going to be able to apply the benefits of the DTA, but exclusively in relation to those incomes that are specifically referred to.

(a). Exercise of an economic activity (Art. 17.4)

Notwithstanding the fact that it cannot be considered a “qualified person” under the above rules, income obtained by a resident of either the United States or Spain may apply the benefits of the DTA to income obtained in the other country and derived from the exercise of an economic activity, when the following requirements are met:

- (i). The U.S. or Spanish resident must engage in an economic activity other than investment or investment management for its own account unless it is a registered bank, insurance company or securities dealer.
- (ii). When the U.S. or Spanish income is obtained directly in its own State of residence, without the need for any presence in the country of the source, the income must be related or incidental to the carried out economical activities.

(iii). When the U.S. or Spanish company's income result from an economic activity carried out in the country in which it is not resident (source country) either directly or from a related party² the DTA application requires that the income should be considered "substantial" to the activity carried out in that other (source) country. All facts and circumstances shall be taken into account in determining substantial character. Activities carried out by a related entity shall be deemed to be carried out directly by the other related party.

(b). Head Office (Art 17.5)

This section allows the application of DTA profits to those income received by an entity that is considered the "headquarters" of a multinational group and the income comes from the economic activities carried out by the multinational group. In order for such benefits to apply, the resident person must be a head office, the group of enterprises must effectively be multinational and the income subject to the DTA must derive from the business of the multinational group.

(i). **The resident entity must act as a headquarters**, it is not essential for the latter to own shares in the companies it oversees, but it must assume a substantial part of the "supervision and administration" of the group. Among others, the activities to be undertaken would be the following: (i) internal communication, (ii) internal audit, (iii) marketing, (iv) management, (v) pricing policies, (vi) group financing (however, the financing activity can not constitute the main activity of the headquarters)

The performance of such functions by the head office should be substantial compared to the same functions performed by other entities in the same group.

In the exercise of its activity, the headquarters must act with discretion and autonomy in the execution of its functions (the existence of autonomy would be analysed function by function, with the possibility of some advocating such autonomy and others not).

The head office must be subject to the general tax regime for economic activities.

² The ADT considers two persons to be related when so inferred from the facts and circumstances of the case, when one of them has control of the other or both are under the control of the same person or persons. In particular, an entity is considered to be related when another entity has a shareholding of at least 50% (voting rights, security or capital) or when a third party has such a shareholding in both. Two persons are also considered to be related when one participates - directly or indirectly - in the management, control or capital of the other or when the same persons have such a shareholding in both.

- (ii). The Group must be truly multinational. The head office-supervised Group is required to have a presence in at least 5 countries where economic activity is actively pursued and that in each of these countries obtains at least 10 per cent of the group's gross income and a maximum of 50 per cent are obtained (except in the country of residence of the headquarters where the percentage of income may be higher). The income from the other State may not exceed 25 per cent of the gross income of the head office. For the purpose of quantifying the above limits, the gross income of both the group and the head office can be averaged over the preceding four years. Furthermore, country's above limits can be calculated grouping a number of countries.
- (iii). Income earned by the head office from the other state (US or Spain) must be connected to or incidental to the economic activity of the group.

(c). Unilateral recognition by the State administration of the source

As a residual clause, the new Protocol grants the Spanish and U.S. Tax Administrations the power to grant the status of qualified person or to apply the benefits of the DTA in cases to which it would not initially apply.

Such recognition will normally be granted by the State in which it is not resident. In order for such recognition to take place, the authority seeking to grant such benefits shall consider the degree of compliance with the requirements of the said Article 17 and the opinion of the authority of the State of residence, if any.

4. Triangular cases: income attributable to a PE in a third State (Art.17.6)

In certain situations, Spain considers profits obtained by PE in foreign countries to be exempt. When the PE is not subject to taxation analogous to that applicable in Spain, the benefits of the DTA would not be applicable.

Thus, when the income subject to the DTA is attributable to a PE held by Spain in a third country, the US will not be obliged to apply the profits of the DTA to such income if the total tax paid on the income (both in the country of the PE and in Spain) does not reach at least 60% of the general rate applicable in Spain.

Where an entity of a Contracting State obtains income from the other Contracting State, if that income is attributable to a PE which the enterprise has in a third State, the DTA shall not be applied to that income if the profits of the PE are subject to an effective rate lower than 60% of the general tax rate applicable in the country of residence.

In these cases, the income attributable to the PE originating in the USA will be subject to US internal regulations, although, with regard to withholding at source for royalties, interest or dividends, this may not exceed 15%.

There are two exceptions to this anti-abuse rule:

First - in relation to the royalties attributable to the PE derived from intangibles developed by the PE itself.

Second - for the rest of the income (other than royalties) attributable to the PE, when they derive from the “active exercise” or are “incidental” to an economic activity on the part of the PE, other than the investment activity, management or mere holding of investments on their own behalf unless carried out by banks or registered securities agents.

IV. Other Amendments

1. Transparent entities (Art 1.6 of the DTA)

The new Article 1.6 introduced by the Protocol allows the benefits of the DTA to be applied to members or participants of “transparent” entities when they receive income which, according to the country of residence of the receiving member or participant, must be directly attributed to them, maintaining the income qualification and without the effective distribution of income being necessary.

The qualification of “transparent entity” will be determined by the internal legislation of the country of destination of the income, being independent of the consideration - as transparent or not - of the country of origin (source) of the income.

The transparent entity may be located either in the US or in Spain or in a third country provided that in the latter case it has signed an information exchange agreement with the country from which the income is earned.

2. Pension transfers (Art. 20.5 of the DTA)

The Protocol amends Article 20 of the DTA with the aim of avoiding taxation when a beneficiary or shareholder of a pension fund situated in the other country transfers the rights from one fund to another fund. According to the DTA, it could only be subject to taxation when there is an effective distribution in favour of the beneficiaries or shareholders.

3. Permanent Establishment definition derived from Exploration Activities

Article 5 is amended to clarify that the twelve-month period, which determines the existence of a PE, affects exploration activities (in addition to works, construction projects or installation), but excluding natural resource exploitation activities, since the latter constitute a PE regardless of their duration (Article 5.2(f) of the DTA).

4. Information Exchange and Administrative Assistance Clause (Art. 27 of the DTA)

The new Protocol lays down a very broad clause on the exchange of information and administrative assistance under which both administrations may exchange - subject only to a limit set by national law - the information required, regardless of whether it is required for the application of the DTA or for the application of any other tax.

The assistance between the two administrations extends to the collection of the corresponding taxes according to the DTA, as well as to the obtaining of evidence, both testimonies and documentary.

The commitment to administrative assistance cannot be limited by the fact that such information is not necessary for the State called upon to collect it.

Likewise, a State can only refuse to provide information when obtaining or providing that information may entail:

- Disclosing a trade secret or an industrial process or information the communication of which is contrary to public security.
- Take administrative action or obtain information that cannot be obtained in accordance with administrative practice or legislation.

V. Arbitration Clause (Art. 26 of the DTA)

Another one of the amendments introduced by the new Protocol is the establishment of compulsory arbitration to resolve certain questions relating to the application of the DTA when public administrations of both States have not been able to resolve it by mutual agreement within a reasonable period of time (usually 24 months).

The DTA (Article 26) regulates the circumstances and conditions under which arbitration becomes binding on the public administrations of both Contracting States two years after the “commencement” of the mutual agreement procedure, as defined in the article itself, although the period of two years may be extended or reduced by agreement of both Contracting States (Article 26.6.(c).(i) of the DTA)

The initiation of arbitration requires that it be requested by the parties without whose request it will not be initiated, the parties must - among other requirements - agree to keep confidential the data that they are provided, suspend the internal claims initiated.

Where the case raised involves several issues, it may be agreed that each of the issues will be resolved in separate arbitral proceedings.

Once the committee of arbitrators has been appointed by the States, each administration shall submit its proposed resolution, which shall be made available to the other State for comment. The person who has initiated the Mutual Agreement Procedure will also be able to make comments, but without being able to propose a resolution to the case.

The committee of arbitrators shall limit itself to taking one of the proposals for resolutions of the administrations and its resolution shall not include any explanation or grounds for the decision.

Once the resolution of the arbitration committee has been communicated, the party initiating the procedure may accept or reject it. In general, a period of 45 days is set for such a decision.

The DTA establishes that the fees and costs of arbitration shall be fairly borne by the States.

We hope you find this information useful and we remind you that Roca Junyent is at your disposal to expand upon or clarify any question of interest.

Sincerely,

Roca Junyent Tax Department

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