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## ***New protocol to US-Spain treaty signals possible changes in US policy on limitation on benefits***

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### ***In brief***

The United States and Spain signed, on January 14, 2013, a new protocol amending the existing 1990 income tax treaty between the United States and Spain, together with a memorandum of understanding (MOU). The protocol is a significant development in that it modernizes the existing treaty and more closely conforms with both countries' current tax treaty policies. Specifically, the protocol provides for exclusive residence-state taxation of interest, royalties, certain capital gains and certain parent-subsidiary dividends. The protocol includes updated limitation on benefits (LOB) and exchange of information articles, and also contains a mandatory binding arbitration provision.

While the protocol modernizes the provisions of the existing treaty, the LOB article represents a fundamental shift in US tax treaty policy in certain respects. For example, the protocol fundamentally changes long accepted US tax treaty standards under which a taxpayer may seek a discretionary grant of benefits in a case where the taxpayer does not satisfy the requirements of the tests set forth in the LOB. The protocol also adds a new restriction on the ability to meet the derivative benefits/equivalent beneficiaries test for treaty eligibility.

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### ***In detail***

#### ***Key provisions of the protocol and MOU***

##### ***Residence state taxation of parent-subsidiary dividends***

Like a number of other recent US tax treaties and protocols, the protocol exempts certain parent-subsidiary dividends from source state taxation. For this provision to apply, the beneficial owner of the dividends must be a company that is a resident of the other

Contracting State and that has owned, directly or indirectly through one or more residents of either Contracting State, shares representing at least 80% of the voting stock of the company paying the dividends. This ownership requirement must have been satisfied for the 12-month period ending on the date on which entitlement to the dividend is determined. In addition, the beneficial owner of the dividends must satisfy the requirements of: (i) the publicly traded or subsidiary of a

publicly traded company test; (ii) the ownership-base erosion test and active trade or business test; (iii) the derivative benefits test; or (iv) the discretionary grant of treaty benefits provision. If the above criteria are not met, source state taxation of dividends may be reduced to five percent of the gross amount of the dividends if the beneficial owner is a company that owns at least ten percent of the voting stock of the company paying the dividends, and is reduced to

15% in most other cases (with special rules for RICs and REITs).

### **LOB Article: more restrictive policy**

#### **Publicly traded company test**

Consistent with current US tax treaty policy, the publicly traded company test imposes an additional requirement that the tested company have a substantial presence in the Contracting State where it is resident, based on either where shares are principally traded or where the company's primary place of management and control is located.

#### **Ownership-base erosion test**

Also consistent with the 2006 US model treaty and current US treaty policy, the protocol's ownership-base erosion test looks only to ownership by persons who are residents of the tested company's state of residence. In the past, US tax treaties have permitted ownership by certain US persons. As with other recent US tax treaties, the ownership prong of the test requires that in the case of intermediate owners, each such owner is a resident of the Contracting State in which the tested company is resident.

#### **Derivative benefits test**

Treaty benefits may be available based on the derivative benefits test, allowing eligibility for treaty benefits if 95% or more of the tested company shares are owned by seven or fewer equivalent beneficiaries entitled to equivalent treaty benefits under another treaty and meeting certain other conditions. However, the protocol requires that, to satisfy the test's ownership requirement, any intermediate owner between the tested company and the qualifying owner must be a resident of a European Union (EU) member state or party to the North American Free

Trade Agreement (NAFTA), as those terms are defined in the treaty.

**Observation:** This protocol is the first US derivative benefits LOB provision to impose a residence requirement with respect to intermediate owners; it is understood that this change was implemented in order to be consistent with the requirements of the ownership-base erosion test, although one can question whether this consistency is appropriate given the different rationales behind the two tests. This more restrictive approach likely will be seen in future US tax treaties and protocols.

#### **Headquarters company test**

The protocol adds a headquarters company test to the LOB article. Broadly, this test requires that the tested company function as a headquarters company for a multinational corporate group, which is demonstrated by satisfying seven criteria. These criteria include requirements that: (i) the tested company provide a substantial portion of the overall supervision and administration of the group; (ii) the corporate group consist of corporations resident in and engaged in an active business in at least five countries and that each of these businesses generate at least ten percent of the gross income of the group; (iii) the business activities carried on in any country (other than the country of residence of the tested company) generate less than 50% of the gross income of the group; (iv) not more than 25% of the tested company's gross income is derived from the other Contracting State; (v) the tested company has and exercises independent discretionary authority to carry on the overall supervision and administrative functions of the corporate group; (vi) the tested company is subject to the same rules

of taxation in its state of residence as companies that satisfy the requirements of the active trade or business test; and (vii) the income derived in the other Contracting State is derived in connection with or incidental to the active trade or business referred to in (ii).

Although the headquarters company test may be limited in its application because of the multiple and strict criteria, it could be an alternative way for a company to qualify for treaty benefits that does not otherwise satisfy any of the article's other provisions.

#### **Triangular branch rule**

The protocol contains a triangular branch rule which provides that in the case where income derived by a resident of one Contracting State from the other Contracting State is attributable to a permanent establishment (PE) in a third jurisdiction, the tax benefits otherwise available under the treaty will not apply if the PE's profits are subject to a combined aggregate effective tax rate in the residence state and third jurisdiction that is less than 60% of the general rate of corporate tax in the residence state. If the tested company fails the 60% test, the source Contracting State may impose a tax not to exceed 15% of the gross amount of dividends, interest or royalties; and any other income is subject to tax under the domestic tax laws of the source state. The triangular branch rule does not apply to royalties paid in connection with intangible property produced or developed by the PE. It also does not apply to income derived in connection with, or incidental to, the active conduct of a trade or business in the PE jurisdiction (other than an investment business unless carried on by a bank or registered securities dealer).

**Observation:** Although not the norm in US tax treaties, the triangular branch rule often is included in treaties with countries whose domestic laws exclude all or a portion of a resident company's income attributable to a PE.

#### **Discretionary grant of benefits**

As noted above, the protocol fundamentally changes long accepted US tax treaty standards under which a taxpayer may seek a discretionary grant of benefits in a case where the taxpayer does not satisfy the requirements of the tests set forth in the LOB. Most US tax treaties apply the following standard: whether the establishment, acquisition or maintenance of the tested company or the conduct of its operations has or had as one of its principal purposes the obtaining of benefits under the relevant treaty. In contrast, the protocol imposes a significantly more restrictive standard that requires an evaluation of the extent to which the resident satisfies the requirements of the qualified persons tests (which includes the publicly traded company, subsidiary of a publicly traded company and ownership-base erosion tests), the derivative benefits test, the active trade or business test and the headquarters company test.

**Observation:** This more stringent standard, which is new with this protocol, means that treaty benefits could be denied to companies that can demonstrate to the satisfaction of the US Competent Authority that they have no 'treaty shopping' purpose, but that do not come close to satisfying one of the objective tests in the LOB article. Treasury representatives have publicly commented that consideration is being given to making this the new policy for all future tax treaties.

#### **Prevention of double taxation on investments between Puerto Rico and Spain**

The MOU includes a provision requiring the United States and Spain to commit to initiate discussions no later than six months after the entry into force of the protocol on avoiding double taxation on investments between Puerto Rico and Spain. The 1990 protocol included a similar provision.

#### **Fiscal transparency rule**

Since 1997, most US tax treaties include a provision addressing income, profits and gains derived through an entity that is fiscally transparent under the laws of either of the Contracting States. The rule is comparable to the rule found in Treas. Reg. §1.894-1(d), except the regulation only applies to fixed or determinable annual or periodic income. The standard US tax treaty rule provides that an item of income, profit or gain derived through an entity that is fiscally transparent under the laws of either Contracting State is considered to be derived by a resident of a Contracting State if the item of income, profit or gain is treated under the laws of the residence state as an item of income, profit or gain of a resident. The protocol's fiscal transparency rule is more restrictive in that it applies only if the entity is organized in the United States, Spain or a jurisdiction that has a tax information exchange agreement in force with the source state.

**Observation:** As a result, a US company that derives income from Spain through a fiscally transparent entity organized in a jurisdiction outside of the United States and Spain that does not have an exchange of information agreement in force with Spain will not be able to claim reduced Spanish taxation or exemption otherwise available under the treaty.

#### **Effective date**

The protocol will enter into force on the date that Spain and the United States have notified each other that they have complied with their required internal procedures. It will be effective with respect to the withholding provisions three months after its entry into force. With respect to taxes determined with reference to a taxable period, it will be effective for taxable periods beginning on or after the protocol enters into force. All other provisions of the protocol will be effective on the date on which the protocol enters into force.

Presently, the protocol has not been sent to the US Senate Foreign Relations Committee to begin the ratification process. Typically, the committee holds one hearing a year on tax agreements and does not schedule hearings until there is a critical mass of pending tax and trade agreements. Three bilateral tax agreements (a new income tax treaty with Hungary and protocols to the income tax treaties with Switzerland and Luxembourg) were reported out by the committee to the full Senate in 2011 with the recommendation that they should be approved. Ordinarily, the full Senate follows the recommendations of the committee, and generally will approve the proposed agreements by unanimous consent. However, these three pacts were not approved by the full Senate because Senator Rand Paul (R-Kentucky) blocked their approval by unanimous consent and no tax treaties have advanced through the Senate approval procedures since that time. Senator Paul's action continues to leave the tax treaty ratification process in a state of flux for the time being.

#### **The takeaway**

Certain provisions of the protocol and MOU, particularly with regard to the LOB article, reflect a fundamental

shift in US tax treaty policy and are likely to be replicated in other bilateral US tax agreements under negotiation.

### ***Let's talk***

For a deeper discussion, please contact:

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