GMS Flash Alert

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United States - Protocol Amending U.S.-Spain Tax Treaty Approved

On July 16, 2019 the U.S. Senate voted in favor of ratifying the new protocol amending the income tax treaty and existing protocol between the United States and Spain.[1] The new protocol is accompanied by a memorandum of understanding (MOU) between the two countries. It makes substantial changes to the existing treaty, which entered into force in 1990, and is intended to bring it into closer conformity with the current income tax treaty policies of the respective countries. The new protocol was originally signed in 2013 and was transmitted to the Senate for its approval in 2014. Final approval of the new protocol had been delayed in the Senate since that time.

WHY THIS MATTERS

The vote in favor of ratification of this new protocol represents an important breaking of the logjam that has prevented new treaties and protocols from coming into effect since 2009. There is some expectation that the pending protocols between the United States and Japan, Switzerland and Luxembourg will also be approved by the Senate within the near future.[2]

The new protocol includes a provision that is intended to provide relief to individuals who participate in a pension plan based in one country while working in the other country. However, an apparent oversight in the drafting of this provision means that individuals resident in the United States who participate in Spanish pension plans may not be able to claim the benefit of this provision.

Changes are also made to the treatment of cross-border investment income (interest, dividends, and capital gains), and there is a new exemption from source country tax on dividends paid to pension funds based in the other country.

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Effective Date

The United States and Spain must notify each other once the approval processes with respect to the new protocol have been completed in the respective countries. The new protocol will enter into force three months after the later of these two notifications. However, the date on which it enters into force is not necessarily the date on which each of its provisions take effect.

The provisions of the new protocol with respect to taxes withheld at source (such as dividends, interest and royalties) will take effect for amounts paid or credited on or after the date on which the new protocol enters into force. For other purposes, its provisions will take effect for tax years beginning on or after the date on which it enters into force. Thus, if the later of the two notifications referred to above occurs before the end of 2019, the new protocol will take effect for all purposes other than withholding for the 2020 tax year.

Dividends

Under the new protocol, dividends will be exempt from withholding tax in the country of source if paid to a pension fund resident in the other country. The new protocol and the MOU provide detailed definitions of which plans in each country meet the definition of a pension plan for purposes of the treaty. In the United States, these include most statutory qualified plans such as 401(k) plans, profit sharing and stock bonus plans, and also individual retirement arrangements such as IRAs and Roth IRAs.

Certain parent-subsidiary dividends are also exempt from source country withholding tax if the parent company owns at least 80 percent of the stock of the subsidiary and meets certain other conditions. If these conditions are not met, dividends paid to a company that owns at least 10 percent of the paying company are subject to a 5-percent withholding tax. All other dividends continue to be subject to a 15-percent withholding tax.

The new protocol also adds a provision to the treaty that gives a broad and flexible definition to the term "dividends." This definition is intended to cover all arrangements that yield a return on an equity investment in a corporation, as determined under the domestic law of the country of source.

Interest

The new protocol eliminates withholding tax on most interest payments. The current treaty imposes a 10-percent withholding tax on interest. Under the new protocol, the 10-percent withholding tax on interest would remain in effect only for certain contingent interest arising in the United States that does not qualify as portfolio interest under U.S. domestic law and for certain real estate mortgage investment conduits subject to U.S. tax under U.S. domestic law.

Royalties

The new protocol exempts all royalties from source country withholding tax with the result that such income would be subject to tax only in the country of residence of the payee. Under the existing treaty, royalty payments are subject to source country tax of 5, 8, or 10 percent, depending on the nature of the royalty.

Capital Gains

The new protocol deletes a provision from the capital gains article of the existing treaty that permits one country to tax a resident of the other country on gains from the sale or exchange of stock or other rights in a company or other entity that is resident in the first country, if the recipient of the gain had a 25 percent or greater participation right in the company or other entity. This provision of the treaty enabled Spain to impose tax on gains from the sale of stock in a Spanish entity by a nonresident investor. (The United States generally does not impose tax on Spanish resident investors

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selling stock in U.S. companies unless the company is a U.S. real property holding company or the investor is otherwise engaged in a U.S. trade or business.)

The new protocol adds a new provision to the treaty permitting either country to tax gains from the sale of shares or other rights that directly or indirectly entitle the owner to the enjoyment of real property situated in that country. This provision reflects Spain's prevailing policy of taxing gains from the sale of share or other rights in entities that own Spanish real estate, without regard to the percentage of ownership in such entities.

Pension Income

The new protocol adds a provision to the pensions article of the treaty providing that income earned by a pension fund is taxable to the individuals participating in that fund only when, and to the extent that, it is actually paid to or for the benefit of such individuals. As discussed above in relation to dividends, the new protocol and MOU include detailed definitions of which plans in each country meet the definition of a pension plan for purposes of the treaty.

KPMG NOTE

It appears that the intention of this provision is to provide relief from host country taxation on pension earnings for individuals who continue to participate in their home country pension plans while working in the host country. However, if an individual who has been participating in a Spanish pension plan moves to the United States for employment purposes and becomes a U.S. resident while continuing to participate in the Spanish pension plan, that individual would not get relief from current U.S. tax on the pension income under this provision because the new protocol does not expressly exclude this provision from the scope of the saving clause. The effect of the saving clause is to permit the United States to tax its citizens and residents notwithstanding any provision of the treaty, unless such provision is expressly excepted from the scope of the saving clause. It remains to be seen whether this apparent oversight will be addressed by way of an exchange of notes between the two countries or other guidance issued in relation to the treaty.

FOOTNOTES:

1 Protocol Amending the Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income and its Protocol, signed at Madrid on February 22, 1990 (Treaty Doc. 113-4).

2 For prior coverage, see GMS *Flash Alert* 2019-107 (June 26, 2019).

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