EXPLANATION OF PROPOSED PROTOCOL TO THE INCOME TAX TREATY BETWEEN THE UNITED STATES AND SPAIN

Scheduled for a Hearing
Before the
COMMITTEE ON FOREIGN RELATIONS
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INTRODUCTION

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, describes the proposed protocol between the United States and Spain (the "proposed protocol") to amend the existing treaty ("1990 treaty" or "existing treaty"). The proposed protocol was signed on January 14, 2013, and includes provisions amending the existing protocol ("1990 protocol") as well as a contemporaneous Memorandum of Understanding, all executed through an exchange of diplomatic notes. In addition, an exchange of diplomatic notes was executed July 23, 2013 ("the July exchange of notes"). The Senate Committee on Foreign Relations has scheduled a public hearing on the proposed protocol for June 19, 2014.[2]

Part I of the pamphlet provides a summary of the proposed protocol. Part II provides a brief overview of U.S. tax laws relating to international trade and investment and of U.S. income tax treaties in general. Part III provides a brief overview of the tax laws of Spain. Part IV provides a discussion of investment and trade flows between the United States and Spain. Part V explains, in order, each article of the proposed protocol, followed by an explanation of the paragraphs in the Memorandum of Understanding. Part VI describes issues that members of the Committee on Foreign Relations may wish to consider in their deliberations over the proposed protocol.

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[1] This document may be cited as follows: Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Spain* (JCX-67-14), June 17, 2014. References to "the Code" are to the U.S. Internal Revenue Code of 1986, as amended. This document is available on the internet at http://www.jct.gov.

[2] For a copy of the proposed protocol, see Senate Treaty Doc. 113-4.

I. SUMMARY

The principal purposes of the proposed protocol are to reduce or eliminate double taxation of income earned by residents of each country from sources within the other country, and to prevent avoidance or evasion of the taxes of the two countries. The proposed protocol also is intended to promote closer economic cooperation between the two countries and to eliminate possible barriers to trade and investment caused by overlapping taxing jurisdictions of the two countries. As in other U.S. tax treaties, these objectives principally are achieved through each country's agreement to limit, in certain specified situations, its right to tax income derived from its territory by residents of the other country.

For example, the proposed protocol includes provisions that clarify the scope of the treaty and its applicability to payments received through fiscally transparent entities (Article I) and provides rules for the appropriate standard for defining an otherwise undefined term used in the treaty (Article II).

The proposed protocol also includes provisions under which each country generally agrees not to tax business income derived from sources within that country by residents of the other country unless the business activities in the taxing country are substantial enough to constitute a permanent establishment (Article III).

The proposed protocol replaces the provisions on dividends, interest, and royalties in the existing treaty with new provisions on dividends, interest, and royalties that are generally consistent with the U.S. Model treaty (Articles IV, V, and VI). The new provisions generally exempt interest and royalties from source-country taxation. The new rules for dividends reduce source-country taxation of dividends and, like a number of other recent U.S. income tax treaties but in contrast with the U.S. Model treaty, provide a zero rate of withholding for certain parent-subsidiary dividends.

The proposed protocol amends the article on capital gains in the existing treaty and allows for source-country taxation on the disposition of shares or other rights which directly or indirectly entitle the owner to the enjoyment of immovable property situated in the source country (Article VII).

The proposed protocol deletes the article on branch taxes in the existing treaty (Article VIII), but adds the branch tax rules to Article 10 (Dividends).

The proposed protocol replaces the limitations on benefits provision in the existing treaty with a new detailed limitation-on-benefits provision (Article IX). The new provision reflects the anti-treaty-shopping provisions included in the United States Model Income Tax Convention of November 15, 2006 (the "U.S. Model treaty") and more recent U.S. income tax treaties. The rules are intended to prevent the inappropriate use of the treaty by third-country residents.

The proposed protocol amends the article on pensions, providing that the income earned by the pension fund may only be taxed when the income is distributed (Article X).

The proposed protocol extends the mutual agreement procedures to require arbitration when the competent authorities of the two countries are otherwise unable to resolve disputes after a reasonable period of time (Article XII).

The proposed protocol replaces the exchange information and administrative assistance provision that is consistent with the U.S. Model treaty and more recent U.S. income tax treaties. It also authorizes administrative collection assistance to ensure that reduced withholding rates and certain exceptions are not extended to persons not intended to receive such benefits (Article XIII).

The proposed protocol includes amendments to the 1990 protocol (Article XIV).

The provisions of the proposed treaty will have effect generally for taxable periods beginning on or after January 1 of the calendar year immediately following the date on which the proposed protocol enters into force. With respect to withholding taxes (on, for example, dividends, interest or royalties), the proposed protocol has effect for amounts paid or credited on or after the first day of the second month following the date on which the proposed protocol enters into force (Article XV).

The rules of the proposed protocol generally are similar to rules of recent U.S. income tax treaties, the U.S Model treaty,[3] and the 2010 Model Tax Convention on Income and on Capital of the Organisation for Economic Co-operation and Development (the "OECD Model treaty"). The proposed protocol does, though, include certain substantive deviations from these treaties and models. These deviations are noted throughout the explanation of the proposed protocol in Part V of this pamphlet and are discussed in Part VI.

[3] For a comparison of the U.S. Model treaty with its 1996 predecessor, *see* Joint Committee on Taxation, *Comparison of the United States Model Income Tax Convention of September 20, 1996 with the United States Model Income Tax Convention of November 15, 2006* (JCX-27-07), May 8, 2007.

II. OVERVIEW OF U.S. TAXATION OF INTERNATIONAL TRADE AND INVESTMENT AND U.S. TAX TREATIES

This overview briefly describes certain U.S. tax rules relating to foreign income and foreign persons that apply in the absence of a U.S. tax treaty. This overview also discusses the general objectives of U.S. tax treaties and describes some of the modifications to U.S. tax rules made by treaties.

A. U.S. Tax Rules[4]

The United States taxes its citizens, residents, and corporations on their worldwide income, whether derived in the United States or abroad. The United States generally taxes nonresident alien individuals and foreign corporations on all of their income that is effectively connected with the conduct of a trade or business in the United States (sometimes referred to as "effectively connected income"). The United States also taxes nonresident alien individuals and foreign corporations on certain U.S.-source income that is not effectively connected with a U.S. trade or business.

Income of a nonresident alien individual or foreign corporation that is effectively connected with the conduct of a trade or business in the United States generally is subject to U.S. tax in the same manner and at the same rates as income of a U.S. person. Deductions are allowed to the extent that they are related to effectively connected income. A foreign corporation also is subject to a flat 30-percent branch profits tax on its "dividend equivalent amount," which is a measure of the effectively connected earnings and profits of the corporation that are removed in any year from the conduct of its U.S. trade or business. In addition, a foreign corporation is subject to a flat 30-percent branch-level excess interest tax on the excess of the amount of interest that is deducted by the foreign corporation in computing its effectively connected income over the amount of interest that is paid by its U.S. trade or business.

U.S.-source fixed or determinable annual or periodical income of a nonresident alien individual or foreign corporation (including, for example, interest, dividends, rents, royalties, salaries, and annuities) that is not effectively connected with the conduct of a U.S. trade or business is subject to U.S. tax at a rate of 30 percent of the gross amount paid. Certain insurance premiums earned by a nonresident alien individual or foreign corporation are subject to U.S. tax at a rate of one or four percent of the premiums. These taxes generally are collected through withholding. Certain payments of U.S.-source income paid to foreign financial institutions and other foreign entities also are subject to withholding tax at a rate of 30 percent unless the foreign financial institution or foreign entity is compliant with specific reporting requirements.

Specific statutory exemptions from the 30-percent withholding tax are provided. For example, certain original issue discount and certain interest on deposits with banks or savings institutions are exempt from the 30-percent withholding tax. An exemption also is provided for

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[4] The U.S. tax rules are codified in Title 26, of the United States Code, referred to as the Internal Revenue Code of 1986, as amended ("IRC"). Unless otherwise stated, all section references in this document are to the IRC.

certain interest paid on portfolio debt obligations. In addition, income of a foreign government or international organization from investments in U.S. securities is exempt from U.S. tax.

U.S.-source capital gains of a nonresident alien individual or a foreign corporation that are not effectively connected with a U.S. trade or business generally are exempt from U.S. tax, with two exceptions: (1) gains realized by a nonresident alien individual who is present in the United States for at least 183 days during the taxable year, and (2) certain gains from the disposition of interests in U.S. real property.

Rules are provided for the determination of the source of income. For example, interest and dividends paid by a U.S. resident or by a U.S. corporation generally are considered U.S.-source income. Conversely, dividends and interest paid by a foreign corporation generally are treated as foreign-source income. Notwithstanding this general rule that dividends and interest are sourced based upon the residence of the taxpayer making such a payment, special rules may apply in limited circumstances to treat as foreign source certain amounts paid by a U.S. resident taxpayer and treat as U.S. source certain amounts paid by a foreign resident taxpayer.[5] Rents and royalties paid for the use of property in the United States are considered U.S.-source income.

Because the United States taxes U.S. citizens, residents, and corporations on their worldwide income, double taxation of income can arise when income earned abroad by a U.S. person is taxed by the country in which the income is earned and also by the United States. The United States seeks to mitigate this double taxation generally by allowing U.S. persons to credit foreign income taxes paid against the U.S. tax imposed on their foreign-source income. A fundamental premise of the foreign tax credit is that it may not offset the U.S. tax liability on U.S.-source income. Therefore, the foreign tax credit provisions contain a limitation that ensures that the foreign tax credit offsets only the U.S. tax on foreign-source income. The foreign tax credit limitation generally is computed on a worldwide basis (as opposed to a "per-country" basis). The limitation is applied separately for certain classifications of income. In addition, a special limitation applies to credits for foreign oil and gas taxes.

For foreign tax credit purposes, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation and receives a dividend from the foreign corporation (or is otherwise required to include in its income earnings of the foreign corporation) is deemed to have paid a portion of the foreign income taxes paid by the foreign corporation on its accumulated earnings. The taxes deemed paid by the U.S. corporation are included in its total foreign taxes paid and its foreign tax credit limitation calculations for the year in which the dividend is received.

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[5] For tax years beginning before January 1, 2011, all (or a portion) of a payment of interest by a resident alien individual or domestic corporation was treated as foreign source if such individual or corporation met an 80-percent foreign business requirement. Although this provision generally was repealed for tax years beginning after December 31, 2010, other rules still apply to treat certain payments of interest by a foreign bank branch or foreign thrift branch of a domestic corporation or partnership as foreign source. Similarly, several rules apply to treat as U.S. source certain payments made by a foreign resident. For example, certain interest paid by a foreign corporation that is engaged in a U.S. trade or business at any time during its taxable year or has income deemed effectively connected with a U.S. trade or business during such year is treated as U.S. source.

B. U.S. Tax Treaties

The traditional objectives of U.S. tax treaties have been the avoidance of international double taxation and the prevention of tax avoidance and evasion. Another related objective of U.S. tax treaties is the removal of the barriers to trade, capital flows, and commercial travel that may be caused by overlapping tax jurisdictions and by the burdens of complying with the tax laws of a jurisdiction when a person's contacts with, and income derived from, that jurisdiction are minimal. To a large extent, the treaty provisions designed to carry out these objectives supplement U.S. tax law provisions having the same objectives; treaty provisions modify the generally applicable statutory rules with provisions that take into account the particular tax system of the treaty partner.

The objective of limiting double taxation generally is accomplished in treaties through the agreement of each country to limit, in specified situations, its right to tax income earned within its territory by residents of the other country. For the most part, the various rate reductions and exemptions agreed to by the country in which income is derived (the "source country") in treaties are premised on the assumption that the country of residence of the taxpayer deriving the income (the "residence country") may tax the income at levels comparable to those imposed by the source country on its residents. Treaties also provide for the elimination of double taxation by requiring the residence country to allow a credit for taxes that the source country retains the right to impose under the treaty. In addition, in the case of certain types of income, treaties may provide for exemption by the residence country of income taxed by the source country.

Treaties define the term "resident" so that an individual or corporation generally will not be subject to tax as a resident by both of the countries. Treaties generally provide that neither country may tax business income derived by residents of the other country unless the business activities in the taxing jurisdiction are substantial enough to constitute a permanent establishment or fixed base in that jurisdiction. Treaties also contain commercial visitation exemptions under which individual residents of one country performing personal services in the other are not required to pay tax in that other country unless their contacts exceed certain specified minimums (for example, presence for a set number of days or earnings in excess of a specified amount). Treaties address the taxation of passive income such as dividends, interest, and royalties from sources within one country derived by residents of the other country either by providing that the income is taxed only in the recipient's country of residence or by reducing the rate of the source country's withholding tax imposed on the income. In this regard, the United States agrees in its tax treaties to reduce its 30-percent withholding tax (or, in the case of some income, to eliminate it entirely) in return for reciprocal treatment by its treaty partner. In particular, under the U.S. Model treaty and many U.S. tax treaties, source-country taxation of most payments of interest and royalties is eliminated, and, although not provided for in the U.S. Model treaty, many recent U.S. treaties forbid the source country from imposing withholding tax on dividends paid by an 80-percent owned subsidiary to a parent corporation organized in the other treaty country.

In its treaties, the United States, as a matter of policy, generally retains the right to tax its citizens and residents on their worldwide income as if the treaty had not come into effect. The United States also provides in its treaties that it allows a credit against U.S. tax for income taxes paid to the treaty partners, subject to the various limitations of U.S. law.

The objective of preventing tax avoidance and evasion generally is accomplished in treaties by the agreement of each country to exchange tax-related information. Treaties generally provide for the exchange of information between the tax authorities of the two countries when the information is necessary for carrying out provisions of the treaty or of their domestic tax laws. The obligation to exchange information under the treaties typically does not require either country to carry out measures contrary to its laws or administrative practices or to supply information that is not obtainable under its laws or in the normal course of its administration or that would reveal trade secrets or other information the disclosure of which would be contrary to public policy. Several recent treaties and protocols provide that, notwithstanding the general treaty principle that treaty countries are not required to take any actions at variance with their domestic laws, a treaty country may not refuse to provide information requested by the other treaty country simply because the requested information is maintained by a financial institution, nominee, or person acting in an agency or fiduciary capacity. This provision thus explicitly overrides bank secrecy rules of the requested treaty country. The Internal Revenue Service ("IRS") and the treaty partner's tax authorities also can request specific tax information from a treaty partner. These requests can include information to be used in criminal tax investigations or prosecutions.

Administrative cooperation between countries is enhanced further under treaties by the inclusion of a "competent authority" mechanism to resolve double taxation problems arising in individual cases and, more generally, to facilitate consultation between tax officials of the two governments. Several recent treaties also provide for mandatory arbitration of disputes that the competent authorities are unable to resolve by mutual agreement.

Treaties generally provide that neither country may subject nationals of the other country (or permanent establishments of enterprises of the other country) to taxation more burdensome than the tax it imposes on its own nationals (or on its own enterprises). Similarly, in general, neither treaty country may discriminate against enterprises owned by residents of the other country.

At times, residents of countries that do not have income tax treaties with the United States attempt to use a treaty between the United States and another country to avoid U.S. tax. To prevent third-country residents from obtaining treaty benefits intended for treaty country residents only, treaties generally contain "anti-treaty shopping" provisions designed to limit treaty benefits to bona fide residents of either of the two countries.

III. OVERVIEW OF TAXATION IN SPAIN[6]

A. National Income Taxes

Overview

The Kingdom of Spain is a parliamentary monarchy and a member state of the European Union ("EU") and member of the European Economic Area ("EEA").[7] The central government is organized through a bicameral legislative body. Spain is divided into 17 autonomous regions and two autonomous cities (Ceuta and Melilla), each of which also has an elected parliamentary form of government. The authority to tax income is embodied in Article 31 of the Spanish Constitution[8] and is shared by the central government with the regions. The central government imposes income tax on net income of both individuals and corporate entities, while regional or municipal authorities may adjust deductions and applicable rates and also impose license fees and indirect taxes on business activities. Residents are subject to tax on worldwide income while nonresidents are generally subject to tax only on their income from Spanish sources. Income is broadly defined and includes capital gains. Foreign tax credits are generally available to individual and corporate residents to alleviate double taxation.

Individual

Personal income taxes (*impuesto sobre la Renta de las Personas Fisicas*) are levied against worldwide income of individuals on a net basis. A person is considered to be a resident if physically present in Spain for more than 183 days of the year, or if the individual's business and professional activities are based in Spain. Married individuals may file joint returns of income.

Nonresident individuals pay income tax only on their income from Spanish sources.[9]

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[6] This description of Spanish law relies largely on the following secondary sources: Baker & McKenzie Madrid S.L., "Doing Business in Spain" available at http://www.bakermckenzie.com/BKDBISpain13/; Cuatrecasas, Goncalves Pereira S.L.P., "Business Operations in Spain," *BNA Tax Management Portfolio*, 984-5th; Law Library of Congress, *Taxation of Foreign Source Income of Resident Corporations, Report for Congress* (April 2011); Deloitte Touche Tohmatsu Ltd., Spain Highlights 2014, available at http://www2.deloitte.com/content/dam/Deloitte/global/Documents/Tax/dttl-tax-spainhighlights-2014.pdf; and IBFD European Tax Surveys, "Spain – Corporate Taxation" and "Spain-Individual Taxation." The description is intended to serve as a general overview; many details have been omitted and simplifying generalizations made.

[7] The EEA comprises the European Union and three member states of the European Free Trade Association ("EFTA"), Iceland, Norway and Liechtenstein, to form a single European market. The fourth member of EFTA is Switzerland.

[8] Article 31, section 1, provides "Everyone shall contribute to sustain public expenditure in proportion to his or her financial means, through a just and progressive system of taxation based on principles of equity, which in no case shall be of a confiscatory scope." The Spanish Constitution is available at http://www.tribunalconstitucional.es/en/constitucion/Pages/ConstitucionIngles.aspx.

[9] IBFD TAX RESEARCH PLATFORM: SPAIN – KEY FEATURES (updated May 1, 2014), http://online.ibfd.org/kbase/#topic=doc&url=/collections/kf/html/kf_es.html&WT.z_nav=Navigation&colid=4914.

Spanish-source income from employment, self-employment, movable capital, and capital gains derived by resident individuals may be subject to withholding of income tax. The tax withheld is generally treated as an advance payment and credited against the taxpayer's final tax liability.[10]

Employment income, including pensions, is subject to a general withholding tax in accordance with a formula that takes into account the personal and family circumstances of the taxpayer.[11]

Earned income, which includes salaries, professional fees and other business income, is subject to a progressive rate of tax between 24.75 percent and 59 percent. A lower scale of progressive tax applies to passive income, also referred to as savings income. Such income includes dividends, interest and capital gains and is taxed at 21 percent.

Corporate

Corporate income tax (*impuesto sobre Sociedades*) is imposed on net taxable worldwide income of resident corporations. A corporation is considered to reside in Spain if it was formed pursuant to Spanish law, has registered its office in Spain or has its effective place of management in Spain. A corporation that is located in a tax haven or a low-tax jurisdiction[12] but has most of its principal assets or rights thereto in Spain is presumed to be resident in Spain, unless the taxpayer can prove that the corporation is managed in the tax haven jurisdiction and that there are valid economic reasons for it to be established there. Mere management of its securities in the tax haven jurisdiction is insufficient to satisfy this exception.

The corporate income tax is imposed on business profits as well as capital gains and dividends received. Income earned in branches flows up to the parent and is includible in the corporate income. Corporate groups are entitled to file their tax returns on a group basis.

The rate of tax is generally 30 percent, but reduced rates for small businesses are provided depending on the level of gross revenues and number of employees. The rate is 25 percent for the first €300,000 ($407,201.00)[13] of taxable income of a company with sales below €10 million. That rate may be further reduced to 20 percent on the first €300,000 and 25 percent on the balance of taxable income if the company sales do not exceed €5 million ($6.787 million).

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[10] *Ibid.*

[11] *Ibid.*

[12] Spanish regulations list 48 countries as tax havens, including Hong Kong, Cayman Islands, Bermuda, Malta, the Isle of Man, Lichtenstein, Macao, Luxembourg (with respect to income from certain entities), and Singapore. For the complete list of countries deemed to be tax havens under Spanish law, see, Real Decreto 1080/1991 of July 5, 1991, as amended by Real Decreto 116/2003, available at http://www.boe.es/boe/dias/1991/07/13/pdfs/A23371-23371.pdf.

[13] All currency conversions are based on rate of €1.00 equals $$1.36, at www.xe.com, as of June 16, 2014.

Deductions and credits as incentives

In 2013, the corporate income tax was amended to strengthen existing business incentives under the Law to Support Entrepreneurs and Internationalisation ("Entrepreneur Law"),[14] specifically amending the research and development credits, the credit for hiring the disabled, an investment credit for small businesses and liberalization of the patent box regime, described in part B., below. The research and development credits were increased, and in some instances the the credit was made refundable,[15] provided several conditions are met. Those conditions require that at least one year has elapsed since the credit was generated, the research and development activities have continued, investments equal to or greater than the tax credit have been invested in such activities in a two-year period beginning with the end of the tax period for which the refundable credit is claimed and an expert report supporting the characterization of the activities as research and development is provided. The tax credit for increasing hiring disabled workers was changed from a flat rate of €6,000 ($8,144) per employee per year in years in which the average number of disabled employees increases in the taxpayer's workforce to amounts based on the level of disabilities of those in the workforce, up to a maximum credit of €9,000 ($12,216) per employee per year. The new investment credit is available to small companies and micro-enterprises for amounts invested in new equipment or other property used for business purposes. Finally, the Entrepreneur Law clarified the extent to which an entity could avail itself of more than one of the incentives described above.

Deductibility of expenses

Deductions from business profits to determine net income are permitted, with certain exceptions and limitations. Net operating losses may be carried forward, but not back, and are limited for companies with sales of more than €20 million ($27.147million). Deductions for depreciable tangible assets are limited to 70 percent of the otherwise applicable rate for companies with revenues exceeding €10 million.

Until 2012, Spain had thin capitalization rules applicable to related party debt unless the related party is a resident of a member state of the European Union that is not considered a tax haven under Spanish law. If the net interest-bearing debt, either direct or indirect, of an entity (other than a financial institution) owed to one or more related individuals or entities that are not resident in Spain exceeded three times its capital, the interest attributable to the excess was considered a dividend that was not deductible and was subject to any applicable dividend withholding tax. The thin capitalization rule was abolished in 2012 and replaced with a general

[14] This summary of the Entrepreneur Law is largely based on publications of KPMG Abogados S.L., "New Tax Measures introduced by law 14/2013 of27 September 2013, on support for and the internationalization of entrepreneurs," available at http://www.catedraemprenedoria.udl.cat/sites/default/files/Novedades-2013-Ley-14-ingles.pdf, and KPMG, *flash International Executive Alert 2013-144* (October 23, 2013), available at http://www.kpmg.com/US/en/IssuesAndInsights/ArticlesPublications/flash-international-executive-alert/Documents/flash-international-executive-alert-2013-144-oct.pdf.

[15] The amount of credit for research and development activities is increased to 60 percent of the gross tax due less credits to avoid double taxation for companies taxed at a rate of 35 percent, and to 50 percent for those taxed at a rate of 25 percent.

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[15] The amount of credit for research and development activities is increased to 60 percent of the gross tax due less credits to avoid double taxation for companies taxed at a rate of 35 percent, and to 50 percent for those taxed at a rate of 25 percent.

limitation on the deductibility of borrowing costs, subject to a de minimis exception for expenses not in excess of €1million ($1357,340) annually.

B. International Aspects of Tax in Spain

Individual

Nonresident individuals are subject to the nonresident income tax (*impuesto sobre la Renta de No Residentes*) that is generally assessed on a gross basis[16] on income derived from Spanish sources. The rate of tax varies depending on the type of income. Business and employment income, royalties and fees are taxed at 24.75 percent, for 2012, 2013, and 2014, collected via a withholding tax at the same rate.

The withholding tax rate on dividends and interest paid to nonresidents is 19 percent. However, the rate is temporarily increased to 21% for years 2012, 2013, and 2014. This rate may be reduced by a tax treaty or EU rules regarding nonresidents of the EU member states. Interest paid to nonresidents on bank deposits, government bonds, securities issued in Spain by international organizations such as the European Investment Bank are exempt from Spanish withholding tax.[17] Stock dividends distributed free of charge from the earnings or reserves of the company are deemed not to constitute taxable income at the time of issue. Their taxation is deferred until the sale of the shares.

Corporate

Participation exemption

In addition to tax credits to prevent double taxation, Spain grants double tax relief through an exemption from income for qualifying participations. Dividends and capital gains from foreign subsidiaries qualify for an exemption from the Spanish corporate tax if the resident corporation owns a participation of at least five percent of the foreign company and has held the participation for at least one year prior to the date on which the dividend is payable. In addition, certain anti-avoidance criteria must be met for the exemption to apply, chief among them the requirement that the income from the foreign subsidiary must have been subject to tax in the foreign country that is deemed equivalent to the Spanish corporate tax. The subsidiary must have been subject to and not exempt from such tax for the entire year in which the dividend is received. The tax in the foreign country is deemed to be equivalent to the Spanish corporate tax if the foreign subsidiary has a permanent establishment located in a country with which Spain has a tax treaty with an exchange of information clause. At least 85 percent of the foreign subsidiary's income out of which the dividend was paid must be derived from business activities carried on outside Spain. The exemption is not available if any of three conditions apply: The foreign subsidiary is located in a country that is considered a tax haven under Spanish regulations; the main purpose of the subsidiary is to benefit from the tax exemption; or losses of the subsidiary are deductible by way of depreciation of the relevant participation.

[16] IBFD, *supra* note 3.

[17] *Ibid.*

Controlled foreign company rules

Spain has controlled foreign company rules referred to as the "international tax transparency regime." Under this regime, a Spanish resident company is liable for corporate income tax on some passive income, such as interest, dividends, capital gains, and real estate losses, of non-EU resident companies or of companies based in tax haven countries.[18]

These rules apply where the Spanish resident company owns at least 50 percent of the capital, equity, or voting rights, and where the controlled foreign company has "tainted income." Tainted income includes: (1) income from real estate or related rights, unless the real property is effectively connected to a business activity; (2) income derived from participating in the equity of any kind of entity or as a consequence of granting third parties the right to use the company's financial resources;[19] (3) income from financial assets and inter-related company loans, provided the payments have been deducted for Spanish income tax purposes;[20] and (4) capital gains from the transfer of these types of assets accrued by the controlled foreign company. If the controlled foreign company pays local corporate tax on the tainted income that is at least 75 percent of the tax the company would have paid under the Spanish tax regime, it is not subject to these rules.

Income derived from business activities, capital gains, and the transfer of rights of business assets is excluded from taxable income if it is derived from entities in which the Spanish resident corporation has a direct or indirect interest of more than five percent and the following prerequisites are met: (1) the nonresident company has the supervision and management of the participation through the appropriate organization of means and personnel; and (2) at least 85 percent of the income of the entities from which the income is obtained is created by carrying out business activities.

If the amount of passive income derived from the Spanish resident parent company is 15 percent or more of the net profits, or four percent of the total turnover, of the controlled foreign company, the Spanish resident company includes the proportionate share of income in its tax base.

Gain or loss on the sale of foreign subsidiary stock

Capital gains from the sale of foreign subsidiary stock also qualify for an exemption from the Spanish corporate tax if the participation requirements, one-year holding period, and anti-

[18] A controlled foreign company that is resident in a tax haven jurisdiction is deemed to have tainted income of 15 percent of the Spanish shareholder's cost of acquiring the tax haven company, unless the Spanish shareholder provides evidence of contrary income amounts, or includes the tax haven company in its consolidated balance sheet.

[19] This category includes all kinds of financial income derived from equity or debt instruments and includes many exemptions including an exemption for income from credit activities that can be characterized as business activities.

[20] This type of income will not be tainted income if more than 50 percent of the controlled foreign company's income from such activities arises from transactions with unrelated parties.

avoidance criteria discussed above are met. The subsidiary must have been subject to an equivalent tax throughout the entire holding period for capital gains to be excluded.

Foreign branches

Income derived from a foreign branch is exempt from Spanish corporate income tax if the foreign branch is considered a permanent establishment.[21] To be exempt, the income of the foreign permanent establishment must be derived from the carrying out of business activities. This condition is met if at least 85 percent of the income corresponds to income obtained abroad, and is not subject to the deduction under the Spanish income tax regime. Wholesale commerce, services, credit and financing, and insurance and reinsurance are activities which could be considered as deriving foreign income. Additionally, the income derived by the permanent establishment must be subject to tax with an equivalent tax to the Spanish income tax, and must not be located in a tax haven country.

The exemption for foreign branch income does not apply where losses from the branch were allowed in prior tax periods. The exemption applies to the income from the branch only after the losses are fully recaptured. Additionally the exemption for foreign branch income does not apply where the permanent establishment was established abroad for the sole purpose of benefiting from this preferred tax treatment.

Intangible property income

Spain adopted a patent box regime in 2007 that reduces the rate of corporate income tax on income derived from licensing the right to exploit intangible assets. The Entrepreneur Law[22] changed the patent box regime by extending the regime to transfers as well as licensing activity, computing the amount of intangible property income exempt from corporate income tax based on net income rather than gross revenues and eliminating the maximum amount income that may be exempted.[23] Instead of exempting 50 percent of the gross revenues from licensing qualified property, the exemption is now 60 percent of the net income derived from the license or transfer of the right to use qualifying intellectual property. Intellectual property rights included in the incentive regime include patents, drawings or models, plans, secret formulas or procedures, and rights on information related to industrial, commercial, or scientific experiments. The patent box regime does not distinguish between intellectual property income from foreign and domestic sources.

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[21] An entity is considered to be doing business through a permanent establishment if it has any permanent facilities or workplaces abroad where it carries out its business activities in whole or in part. If the activities are located in a country with which Spain has a tax treaty, the provisions of the treaty apply to determine if there is a permanent establishment.

[22] Transition rules provide that prior law remains applicable to licenses in effect prior to the effective date of the statute.

[23] For licenses subject to the law prior to the Entrepreneur Law, the availability of the exemption ends in the fiscal year when sales or revenues from exploitation of the intangible exceed six times the cost of developing the intangible.

In order to qualify for the reduced tax: (1) the intellectual property must have been created by the company transferring the right; (2) the recipient of the right must actually use the intellectual property for business activities; (3) if the recipient is a related company, the intellectual property cannot be used to generate a deductible expense for the transferring company; (4) the recipient company must not be located in a listed tax haven jurisdiction;[24] (5) in the case where one intellectual property contract includes other services, the consideration related to the intellectual property must be clearly differentiated within the contract; and (6) the transferring taxpaying company must keep records of income and expenses pertinent to the intellectual property rights subject to the transfer.

Nonresident corporations are taxable only with respect to their income from Spanish sources. The withholding taxes rates for dividends and interest paid to nonresident corporations is the same as that for individuals, described above.[25] The rate of tax varies depending on the type of income. Business and employment income, royalties and fees are taxed at 24.75 percent, for 2012, 2013, and 2014, collected via a withholding tax at the same rate. The withholding tax rate on dividends and interest paid to nonresidents is generally 19 percent, but is increased to 21% for 2012, 2013, and 2014 and may be reduced by a tax treaty or EU rules regarding nonresidents who are residents in an EU member state. Interest paid to nonresidents on bank deposits, government bonds, securities issued in Spain by international organizations such as the European Investment Bank are exempt from Spanish withholding tax.[26] Stock dividends distributed free of charge from the earnings or reserves of the company are deemed not to constitute taxable income at the time of issue. Their taxation is deferred until the sale of the shares.

[24] However, if the zero-tax jurisdiction is a member state in the European Union, the taxpayer may provide evidence that the entity is economically sound.

[25] IBFD, *supra* note 3.

[26] *Ibid.*

C. Other Taxes

Value-added taxes

Spain imposes an *ad valorem* tax ("VAT") on taxable supplies of goods and services in the mainland and the Balearic Islands.[27] The VAT is an indirect consumption tax that is imposed at time of transfer and collected by a taxable person responsible for remitting the VAT to the tax authorities. The taxable person may be any type of entity or individual in the conduct of a business or profession, regardless of profit motive or infrequency of transactions. The amount of VAT paid by the taxable person in purchasing goods or services for his or her business offsets the amount of tax remitted to authorities. Thus, the incidence of the tax falls on the ultimate consumer of the goods or services. The general rate of tax is 21 percent of the amount of the transaction, but reduced rates apply for certain categories of goods, such as food or necessities, and may include full exemption for certain categories.

Inheritance and gift tax

Spanish residents are subject to inheritance and gift taxes on all gratuitous transfers and certain life insurance proceeds, regardless of the situs of the assets transferred. In contrast, non-resident beneficiaries are taxed only on receipt of Spanish property or rights to property. The progressive rate of tax is stated as a range from 7.65 percent to 34 percent, but is subject to variance based on the degree of relationship between the transferor and the transferee as well as the wealth of the transferee prior to the transfer. As a result of the potential multipliers, the inheritance tax may reach a maximum marginal rate of 81.6 percent. The autonomous regions are authorized to vary the rate or grant exemptions not available at the national level, and do so.[28]

Net worth or wealth taxes

Resident individuals are subject to a net worth tax, levied on worldwide net worth. In calculating net worth, an exemption is available for the resident's main dwelling as well as the first €700,000 ($950,087). The net worth tax is a progressive tax ranging from 0.2 percent to 2.5 percent.

The net-worth tax also applies to nonresidents, at the same rates as applicable to residents, but the basis on which the tax is imposed only with respect to assets in Spain. In calculating net worth of such assets, an exemption is available for the first €700,000 ($950,087).

[27] The areas excluded are the Canary Islands and the autonomous cities of Ceuta and Melilla. All three of those areas impose a slightly different variant of the VAT. Cuatrecasas, Goncalves Pereira S.L.P., "Business Operations in Spain," *BNA Tax Management Portfolio*, 984-5th at pp. A-143 et seq.

[28] Cuatrecasas, Goncalves Pereira S.L.P., "Business Operations in Spain," *BNA Tax Management Portfolio*, 984-5th at pp. A-61 and A-135 to A-141.

Social security

Both employer and employee are required to contribute to fund the social security or "general risk" system. The required contribution equals 28.3 percent of wages. The employee is responsible for 4.7 percent, and the employer pays 23.6 percent.

IV. THE UNITED STATES AND SPAIN: CROSS-BORDER INVESTMENT AND TRADE

A. Introduction

Tax treaties can be viewed as part of a set of economic arrangements, such as trade agreements and bilateral investment treaties, reached between two countries to promote cross-border economic activity. Tax treaties are often concluded between countries that already have significant economic ties and have historically preceded, rather than followed, trade agreements, which suggests that the conclusion of a tax treaty between two countries may provide some foundation for future economic agreements.[29]

By clarifying the assignment of taxing authority between residence and source countries and eliminating the double taxation of income, tax treaties reduce the uncertainty individuals and businesses may face when deciding to work or invest in another country and can increase after-tax returns to economic activity in cases where income may have been subject to double taxation or withholding tax. Tax treaties can lead to a more efficient allocation of labor and capital between countries to the extent that they eliminate tax-related barriers to economic activity. The existence of a tax treaty between two countries can also have an indirect effect on investment because the extensiveness of a country's tax treaty network can influence decisions to invest in that country. However, their economic impact depends partly on the character and volume of capital and labor flows between treaty countries and the scope for double taxation of income in the absence of a tax treaty.

Although research on the economic impact of tax treaties has not yielded conclusive results, studies suggest that they have positive impacts on cross-border investment and trade by mitigating double taxation.[30] For example, one study found that, by facilitating the resolution of transfer pricing disputes, the mutual agreement procedures in tax treaties can be particularly beneficial for multinational firms that use inputs whose arm's-length prices are difficult to determine.[31]

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[29] Peter Egger and George Wamser, "Multiple Faces of Preferential Market Access: Their Causes and Consequences," *Economic Policy*, vo. 28, no. 73, January 2013, pp. 143-187.

[30] *Ibid.*

[31] Bruce A. Blonigen, Lindsay Oldenski, and Nicholas Sly, "The Differential Effects of Bilateral Tax Treaties," *American Economic Journal: Economic Policy*, vol. 6, no. 2, May 2014, pp. 1-18.

B. Overview of Economic Activity Between the United States and Spain

Cross-border trade

With a gross domestic product of $582 billion in 2013, Spain has the fifth largest economy of the 28 EU member countries and is one of the more significant U.S. trading partners in the European Union.[32] In 2013, the United States exported $10.2 billion in goods and services to Spain, making Spain the sixth largest destination for U.S. exports to the European Union and 30th largest destination for U.S. exports in the world.[33] U.S. imports of goods and services from Spain totaled $11.7 billion in 2013, which made Spain the seventh largest source of U.S. imports from the European Union and 31st largest source of U.S. imports in the world.[34]

Cross-border direct investment

In 2012, Spain was the eighth largest target for U.S. direct investment ($31.4 billion) in the European Union, and $3.5 billion in direct investment income was generated.[35] Spanish direct investment in the United States totaled $47.3 billion in 2012 (seventh largest among EU member countries), and $1.5 billion in direct investment income was earned.[36]

Income taxes on cross-border income flows

Tax return data provide a complementary snapshot of the economic activity between the United States and Spain. For tax year 2010, Spanish-source gross income (less losses) from U.S. corporate returns with a foreign tax credit totaled $23.0 billion, with the three largest items of income being oil and gas extraction income ($8.3 billion), dividends ($7.8 billion), and rents,

[32] International Monetary Fund, World Economic Outlook Database (April 2014), available at http://www.imf.org/external/pubs/ft/weo/2014/01/weodata/index.aspx.

[33] U.S. Bureau of Economic Analysis and U.S. Census Bureau, U.S. Department of Commerce, "International Trade in Goods and Services: December 2013," February 6, 2014, available at http://www.bea.gov/newsreleases/international/trade/2014/pdf/trad1213.pdf.

[34] *Ibid.*

[35] Bureau of Economic Analysis, U.S. Department of Commerce, "International Economic Accounts," http://www.bea.gov/international. The U.S. Department of Commerce defines an investment as direct when a single person owns or controls, directly or indirectly, at least 10 percent of the voting securities of a corporate enterprise or the equivalent interest in an unincorporated business. Direct investment positions are valued on an historical-cost basis.

[36] *Ibid.*

royalties, and license fees ($1.1 billion).[37] Spanish taxes that were reported on these returns as paid, accrued, or deemed paid totaled $3.0 billion in 2010.[38]

[37] The figure for gross income reported here includes income from the extraction of oil and gas as well as foreign branch income. The data is obtained from Form 1118 filings. See http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-3.

[38] See http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-3.

[illegible] These rules are largely the same as those in the U.S. Model treaty, with one exception.

As the Technical Explanation notes, treaty rules for fiscally transparent entities have two purposes. One goal is to ensure that residents of treaty countries who invest through fiscally transparent entities are entitled to treaty benefits in respect of income derived through the entities if they are subject to tax on the income and are otherwise eligible for treaty benefits in respect of the income. The rules also prevent a resident of one of the treaty countries from claiming treaty benefits in respect of an item of income derived through an entity if the resident does not take into account the income because the entity is not fiscally transparent in the residence country.

Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country and that is formed or organized in either treaty country or in a country that has in force with the treaty country from which the income is derived an agreement

V. EXPLANATION OF PROPOSED PROTOCOL

Article I. General Scope.

The proposed protocol adds two paragraphs to the Article 1 (General Scope) of the 1990 treaty.

Coordination with General Agreement on Trade in Services

The proposed protocol adds rules in new paragraph 5 that relate to non-discrimination obligations of the treaty countries under the General Agreement on Trade in Services (the "GATS"). The provisions of paragraph 5 are an exception to the rule provided in paragraph 2 of Article 1 of the 1990 treaty under which the treaty may not restrict in any manner any exclusion, exemption, deduction, credit, or other allowance accorded by any other agreement between the United States and Spain.

Paragraph 5 provides that, unless the competent authorities agree that a taxation measure is not within the scope of Article 25 (Non-Discrimination), the national treatment obligations of the GATS do not apply to that measure. Further, for purposes of paragraph 3 of Article 22 (Consultation) of the GATS, any question arising as to the interpretation or application of the treaty, including whether a taxation measure is within the scope of the treaty, is determined exclusively in accordance with the provisions of Article 26 (Mutual Agreement Procedure).

According to the Technical Explanation, the result under paragraph 5 of the proposed protocol is that paragraph 3 of Article 22 (Consultation) of the GATS may not be used to bring a dispute before the World Trade Organization unless the competent authorities of both treaty countries have determined that the relevant taxation measure is not within the scope of Article 25 (Non-Discrimination).

Paragraph 5 provides that the term "measure" means a law, regulation, rule, procedure, decision, administrative action, or any similar provision or action.

Fiscally transparent entities

The proposed protocol adds rules for items of income derived through fiscally transparent entities. These rules are largely the same as those in the U.S. Model treaty, with one exception.

As the Technical Explanation notes, treaty rules for fiscally transparent entities have two purposes. One goal is to ensure that residents of treaty countries who invest through fiscally transparent entities are entitled to treaty benefits in respect of income derived through the entities if they are subject to tax on the income and are otherwise eligible for treaty benefits in respect of the income. The rules also prevent a resident of one of the treaty countries from claiming treaty benefits in respect of an item of income derived through an entity if the resident does not take into account the income because the entity is not fiscally transparent in the residence country.

Under these rules, income derived through an entity that is fiscally transparent under the laws of either treaty country and that is formed or organized in either treaty country or in a country that has in force with the treaty country from which the income is derived an agreement

royalties, and license fees ($1.1 billion).[37] Spanish taxes that were reported on these returns as paid, accrued, or deemed paid totaled $3.0 billion in 2010.[38]

[37] The figure for gross income reported here includes income from the extraction of oil and gas as well as foreign branch income. The data is obtained from Form 1118 filings. See http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-3.

[38] See http://www.irs.gov/uac/SOI-Tax-Stats-Corporate-Foreign-Tax-Credit-Table-3.

including a provision for the exchange of information on tax matters is considered to be the income of a resident of one of the treaty countries only to the extent that the income is subject to tax in that country as the income of a resident. For example, if a Spanish company pays interest to an entity that is treated as fiscally transparent for U.S. tax purposes and is formed or organized either in the United States or in a country with which Spain has an agreement in force including a provision for the exchange of information on tax matters, the interest will be considered to be derived by a resident of the United States only to the extent that U.S. tax laws treat one or more U.S. residents (whose status as U.S. residents is determined under U.S. tax laws) as deriving the interest income for U.S. tax purposes.

The scope of the rules for income derived through fiscally transparent entities in the proposed protocol is narrower than the scope of those rules in the U.S. Model treaty and the rules provided in a 2006 mutual agreement between the competent authorities of Spain and the United States (the "2006 competent authority agreement") related to the treatment of limited liability companies, S corporations, and other business entities treated as fiscally transparent for U.S. tax purposes. As described above, the rules of the proposed protocol apply only if the fiscally transparent entity in question is formed or organized in one of the two treaty countries or in a country that has in force with the treaty country from which the income is derived an agreement that includes a provision for the exchange of information on tax matters. By contrast, the U.S. Model treaty rules and the rules of the 2006 competent authority agreement apply without regard to the country of residence of the fiscally transparent entity.

According to the Technical Explanation, the proposed protocol's rules for income derived through fiscally transparent entities apply even if an entity organized in one treaty country is viewed differently under the tax laws of the other treaty country. For example, income from U.S. sources received by an entity organized under the laws of the United States, which is treated for Spanish tax purposes as a corporation and is owned by a Spanish shareholder who is a Spanish resident for Spanish tax purposes, is not considered derived by the shareholder of that corporation even if, under the tax laws of the United States, the entity is treated as fiscally transparent. Rather, for purposes of the treaty, the income is treated as derived by the U.S. entity.

According to the Technical Explanation, the principles of the proposed protocol's rules for income derived through fiscally transparent entities reflect Treas. Reg. section 1.894-1(d). Consequently, with respect to an item of income paid to an entity, the entity is considered fiscally transparent under the laws of the country of residence of a person who holds an interest in the entity to the extent that the laws of that country require the interest holder to separately take into account on a current basis the holder's share of the item of income paid to the entity, whether or not the income is distributed to the interest holder. The Technical Explanation states that entities considered fiscally transparent in the United States include partnerships, subchapter S corporations, common investment trusts under section 584, simple trusts, and grantor trusts. The rules for fiscally transparent entities also apply to payments made to other entities such as U.S. limited liability companies ("LLCs") that may elect to be treated as partnerships or disregarded entities for U.S. tax purposes.

The Technical Explanation states that the treatment of fiscally transparent entities is not an exception to the saving clause. As a result, a treaty country is not precluded from taxing an

entity that is treated as a resident of that country under its tax laws. For example, if a U.S. LLC with Spanish members elects to be taxed as a corporation for U.S. tax purposes, the United States will tax that LLC on its worldwide income on a net basis, without regard to whether Spain views the LLC as fiscally transparent.

The Memorandum of Understanding provides that a resident of a treaty country who is considered to derive an item of income through a fiscally transparent entity in circumstances in which the rules described above apply is entitled to the benefits of the treaty in respect of the item of income only if the resident satisfies all other applicable treaty requirements such as those of Article 1 (General Scope), Article 4 (Residence), and Article 17 (Limitation on Benefits).

Article II. General Definitions

This article of the proposed protocol adds new paragraph (j) to paragraph 1 of Article 3 (General Definitions) of the 1990 treaty, adding definitions for "pension fund" in Spain and the United States.

Under the proposed protocol, the term "pension fund" means in Spain, any scheme, fund, mutual benefit institution or other entity established in Spain that is operated principally to manage the right of its beneficiaries to receive income or capital upon retirement, survivorship, widowhood, orphanhood, or disability; and contributions to which are deductible from the taxable base of personal taxes.

The term "pension fund" means in the United States, any person established in the United States that (1) is generally exempt from income taxation in the United States and (2) operates principally to administer or provide pension or retirement benefits or to earn income principally for the benefit of one or more such persons.

The Memorandum of Understanding, as corrected by the exchange of notes, provides a non-exhaustive descriptive list of the U.S. persons that will be regarded as pension funds for purposes of the 1990 treaty as amended by the proposed protocol, the Memorandum of Understanding, and the exchange of notes. As amended, the term "pension fund" in the United States includes a trust providing pension or retirement benefits under a section 401(a) qualified pension plan (which includes a section 401(k) plan), a profit sharing or stock bonus plan, a section 403(a) qualified annuity plan, a section 403(b) plan, a trust that is an individual retirement account under section 408, a Roth individual retirement account under section 408A, or a simple retirement account under section 408(p), a trust providing pension or retirement benefits under a simplified employee pension plan under 408(k), a trust described in section 457(g) providing pension or retirement benefits under a section 457(b) plan, and the Thrift Savings Fund (section 7701(j)). A group trust described in Revenue Ruling 81-100, as amended by Revenue Ruling 2004-67 and Revenue Ruling 2011-1, qualifies as a pension fund only if it earns income principally for the benefit of one or more pension funds entitled to the benefits as residents of the United States under the treaty.

The Memorandum of Understanding provides a non-exhaustive descriptive list of those Spanish entities that will be regarded as pension funds for purposes of the 1990 treaty as amended by the proposed protocol, the Memorandum of Understanding, and the exchange of

notes. As amended, the term "pension fund" in Spain includes, (1) any find regulated under the Amended Text of the Law on pension funds and pension schemes (*Texto Refundido de la Ley sobre Fondos y Planes de Pensiones*), passed by Legislative Royal Decree 1/2002 of 29th November, (2) any entity defined under Article 64 of the Amended Text of the Law on the regulation and monitoring of private insurances (*Texto Refundido de la Ley de Ordenación y Supervisión de los Seguros Privados*), passed by Legislative Royal Decree 6/2004 of 29th October, provided that in the case of mutual funds all participants are employees; promoters and sponsoring partners are the companies, institutions or individual entrepreneurs to which the employees are engaged; and benefits are exclusively derived from the social welfare agreement between both parties, as well as any other comparable entity regulated within the scope of the political subdivisions (*Comunidades Autónomas*), and (3) insurance companies regulated under the Amended Text of the Law on the regulation and monitoring of private insurances passed by Legislative Royal Decree 6/2004 of 29th October whose activity is the coverage of the contingencies provided for in the Amended Tex of the Law on pension funds and pension schemes.

The Technical Explanation clarifies that the definition, as it applies in the case of the United States, recognizes that pension funds may administer or provide benefits other than pension or retirement benefits, such as death benefits. In order for the fund to be considered a pension fund for purposes of the treaty, the provision of other benefits must be merely incidental to the fund's principal activity of administering or providing pension or retirement benefits.

Additionally, the Technical Explanation clarifies that if a fund that is a collective fund that earns income for the benefit of other funds, then substantially all of the funds that participate in the collective fund must be residents of the same treaty country as the collective fund and must be entitled to benefits under the treaty in their own right.

This article deletes and replaces paragraph 2 of Article 3 of the 1990 treaty regarding the definition of terms not otherwise defined. Any term not defined in the treaty will have the meaning that it has under the law of the country whose tax is being applied, unless the context requires otherwise, and subject to the provisions of Article 26 (Mutual Agreement Procedure). The applicable treaty country law is the law in effect at the time the treaty is being applied, not the law in effect at the time the treaty was signed. If the term is defined under both the tax and non-tax laws of a treaty country, the definition in the tax law prevails. The Technical Explanation clarifies that where the tax laws of the treaty country contain multiple definitions of the same term, the definition used for purposes of the particular provision at issue, if any, should be used.

The Technical Explanation explains that the use of "ambulatory" definitions may lead to results that are at a variance with the intentions of the negotiators and of the treaty countries when the treaty was negotiated and ratified. The inclusion of an exception for where the "context otherwise requires" is intended to address this circumstance. Where reflecting the intent of the treaty countries requires the use of a definition different from the specific definitions in the treaty or the definitions of the law of the treaty country, that different definition will apply. Thus, flexibility in defining terms is necessary and permitted.

Article III. Permanent Establishment

The proposed protocol modifies a provision in the definition of the term "permanent establishment" in the existing treaty, which generally follows the language of other recent U.S. income tax treaties, the U.S. Model treaty, and the OECD Model treaty.

The permanent establishment concept is one of the basic devices used in income tax treaties to limit the taxing jurisdiction of the host country and thus to mitigate double taxation. Generally, an enterprise that is a resident of one country is not taxable by the other country on its business profits unless those profits are attributable to a permanent establishment of the resident in the other country. In addition, the permanent establishment concept is used to determine whether the reduced rates of, or exemptions from, tax provided for dividends, interest, and royalties apply, or whether those items of income will be taxed as business profits.

In general, under the existing treaty, a permanent establishment is a fixed place of business in which the business of an enterprise is wholly or partly carried on. A permanent establishment includes a place of management, a branch, an office, a factory, a workshop, a mine, an oil or gas well, a quarry, or other place of extraction of natural resources.

The modification made by the proposed protocol provides that a permanent establishment includes a building site or a construction or installation project if the site or project lasts for more than 12 months, and includes an installation or drilling rig or ship used for the exploration of natural resources if the activity continues in the treaty country for more than 12 months. By contrast, the existing treaty provides a six-month rule. The change in the proposed protocol to a 12-month test conforms to the U.S. Model treaty. The Technical Explanation states that the 12-month test applies separately to each individual site or project, with a series of contracts or projects that are interdependent both commercially and geographically treated as a single project. The Technical Explanation further states that if the 12-month threshold is exceeded, the site or project constitutes a permanent establishment as of the first day that work in the country began.

Article IV. Dividends

Overview

The proposed protocol replaces Article 10 (Dividends) of the 1990 treaty with a new article that generally allows full residence-country taxation and limited source-country taxation of dividends. The proposed protocol retains both the generally applicable maximum rate of withholding at source of 15 percent and the reduced 10-percent maximum rate for dividends received by a company owning at least 25 percent of the voting stock of the dividend-paying company. Like several other recent treaties and protocols, however, the proposed protocol provides for a zero rate of withholding tax on certain dividends received by a parent company from a subsidiary that is at least 80-percent owned by the parent. A zero rate also generally applies to dividends received by a pension fund.

The proposed protocol also includes special rules for dividends received from regulated investment companies ("RICs") and real estate investment trusts ("REITs"). These special rules are similar to provisions included in other recent treaties and protocols.

Internal taxation rules

United States

The United States generally imposes a 30-percent tax on the gross amount of U.S.-source dividends paid to nonresident alien individuals and foreign corporations. The 30-percent tax does not apply if the foreign recipient is engaged in a trade or business in the United States and the dividends are effectively connected with that trade or business. In that case, the foreign recipient is subject to U.S. tax on the dividends on a net basis at graduated rates in the same manner in which a U.S. person would be taxed.

Under U.S. law, the term "dividend" generally means any distribution of property made by a corporation to its shareholders from current or accumulated earnings and profits.

In general, corporations are not entitled under U.S. law to a deduction for dividends paid. Thus, the withholding tax on dividends theoretically represents imposition of a second level of tax on corporate taxable income. Treaty reductions of this tax reflect the view that where the United States already imposes corporate-level tax on the earnings of a U.S. corporation, a 30-percent withholding rate may represent an excessive level of source-country taxation. Moreover, the reduced rate of tax, or the elimination of source country withholding tax, often applied by treaty to dividends paid to direct investors reflects the view that the source-country tax on payments of profits to a substantial foreign corporate shareholder may properly be reduced further or eliminated to avoid double corporate-level taxation and to facilitate international investment.

A REIT is a U.S. domestic corporation, trust, or association that is subject to the regular corporate income tax, but that receives a deduction for dividends paid to its shareholders if certain conditions are met. To qualify for the deduction for dividends paid, a REIT must distribute most of its income. As a result of the deduction for dividends paid, a REIT generally does not pay Federal income tax. Except for capital gain dividends, a distribution of REIT earnings is generally treated by the recipient as a dividend rather than as income of the same type as the underlying earnings.[39] This distribution is subject to the U.S. 30-percent withholding tax when paid to foreign owners. However, the receipt of a distribution from a REIT is generally treated as a disposition of a U.S. real property interest by the recipient to the extent that it is attributable to a sale or exchange of a U.S. real property interest by the REIT.[40]

A REIT generally is organized to allow investment in primarily passive real estate investments. As such, income of a REIT often includes rentals from real estate holdings or

[39] Because a REIT generally does not pay corporate level tax, certain U.S. benefits of dividend treatment are not available. A U.S. corporate shareholder is not generally entitled to a dividends-received deduction for REIT dividends. REIT dividends generally are not qualified dividends eligible for the 20-percent rate available for individual shareholders.

[40] There is an exception for distributions to a shareholder that owns five percent or less of the REIT, if the REIT stock is regularly traded on an established securities market located in the United States. Sec. 897(h)(1). These distributions are treated as dividends under U.S. internal law.

interest from loans secured by real estate mortgages. Like dividends, U.S.-source rental income of foreign persons generally is subject to the 30-percent withholding tax (unless the recipient makes an election to have the rental income taxed in the United States on a net basis at the regular graduated rates). Unlike the withholding tax on dividends, however, the withholding tax on rental income generally is not reduced in U.S. income tax treaties. When rental income (or interest income) of a REIT is distributed to a foreign shareholder as a REIT dividend, it is treated as a dividend under U.S. internal law. U.S.-source interest income of foreign persons is not subject to U.S. withholding tax in certain circumstances. A REIT dividend does not, however, pass through interest characterization of the REIT's underlying earnings.

U.S. internal law also generally treats a RIC as both a corporation and as an entity not subject to corporate tax to the extent it distributes substantially all of its income. The purpose of a RIC is to allow investors to hold diversified portfolios of securities. Dividends paid by a RIC generally are treated as dividends received by the payee, and the RIC generally pays no tax because it is permitted to deduct dividends paid to its shareholders in computing its taxable income. However, a RIC generally may pass through to its shareholders the character of its net long-term and, before January 1, 2014[41], net short-term capital gains by designating a dividend it pays as a long-term or short-term capital gain dividend, to the extent that the RIC has net capital gains. Nonresident aliens and foreign corporations generally are not subject to tax on capital gains. A distribution before January 1, 2014[42] to a nonresident alien or foreign corporation made by a RIC that is (or, if certain exceptions were disregarded, would be) a U.S. real property holding corporation, however, is treated as gain recognized by that nonresident alien or foreign corporation from the sale or exchange of a U.S. real property interest to the extent the gain is attributable to gain from sales or exchanges of U.S. real property interests.[43]

Similarly, a RIC that earns interest income that would not be subject to U.S. tax if earned by a foreign person directly ("qualified interest income")[44] generally may designate a dividend it pays before January 1, 2014 as derived from that interest income, to the extent of that income. Nonresident aliens and foreign corporations are not subject to tax on interest-related dividends. The aggregate amount that may be designated by a RIC as interest-related dividends generally is

[41] This short-term capital gain designation rule of Code sec. 871(k) was a temporary provision.

[42] This look-through rule for certain distributions by certain RICs was a temporary provision. Sec. 897(h)(1), (4)(a)(i)(II), (4)(a)(ii).

[43] The exception for five-percent-or-less REIT shareholders described above also applies for distributions by RICs.

[44] Qualified interest income of the RIC is equal to the sum of its U.S.-source income with respect to: (1) bank deposit interest; (2) short term original issue discount that is currently exempt from the gross-basis tax under section 871; (3) any interest (including amounts recognized as ordinary income in respect of original issue discount, market discount, or acquisition discount under the provisions of sections 1271-1288, and such other amounts as regulations may provide) on an obligation that is in registered form, unless it is earned on an obligation issued by a corporation or partnership in which the RIC is a 10-percent shareholder or is contingent interest not treated as portfolio interest under section 871(h)(4); and (4) any interest-related dividend from another RIC.

limited to the sum of qualified interest income less the amount of expenses of the RIC properly allocable to the interest income.

Spain

Dividends derived by nonresident individuals are generally subject to a withholding tax of 21 percent of the gross amount of the dividends.

Proposed protocol limitations on internal law

In general

Under the proposed protocol, dividends paid by a company that is a resident of a treaty country to a resident of the other country may be taxed in that other country. The dividends also may be taxed by the country in which the payor company is resident, but the rate of tax is limited. Under the proposed protocol, source-country taxation of dividends (that is, taxation by the country in which the dividend-paying company is resident) generally is limited to 15 percent of the gross amount of the dividends derived and beneficially owned by residents of the other treaty country. A lower rate of five percent applies if the beneficial owner of the dividends is a company that owns directly at least 10 percent of the voting stock of the dividend-paying company.

The term "beneficial owner" is not defined in the 1990 treaty or in the proposed protocol and therefore is defined under the internal law of the country imposing tax (that is, the source country). The Technical Explanation states that the beneficial owner of a dividend for purposes of this article is the person to which the dividend income is attributable for tax purposes under the laws of the source country.

The Technical Explanation gives an example to illustrate the application of the rules for dividends when a resident of a treaty country owns stock of a dividend-paying company through a fiscally transparent entity. In the example, FCo is a Spanish resident company that owns a 50 percent interest in FP, a partnership that is organized in Spain. FP owns 100 percent of the sole class of stock of USCo, a U.S. resident company. Spain treats FP as fiscally transparent under its internal taxation laws and therefore taxes FCo currently on its distributive share of the income of FP. According to the Technical Explanation, FCo is treated as deriving 50 percent of the dividends paid by USCo and is treated as owning directly 50 percent of the USCo stock.

The Technical Explanation states that beneficial ownership principles of the source country - that is, of the country of residence of a company paying dividends - apply to determine whether the person who derives the dividends is the beneficial owner of those dividends. If, for example, the person who derives dividends would not be treated as a nominee, agent, custodian, or conduit under the beneficial ownership principles of a dividend-paying company's country of residence, that person is treated as the beneficial owner of the dividends for purposes of the treaty.

The proposed protocol provides a zero rate of withholding tax for certain intercompany dividends in cases in which there is a sufficiently high (80 percent) level of ownership (often referred to as "direct dividends") and for certain dividends beneficially owned by a pension fund.

Zero rate for direct dividends

Under the proposed protocol, when a company that is a resident of one treaty country receives and beneficially owns dividends paid by a company that is a resident of the other treaty country, the source-country withholding tax rate is reduced to zero if the company receiving the dividends has owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined. Under the 1990 treaty, these dividends may be taxed at a 10-percent rate. The determination whether the 80-percent ownership requirement is satisfied is made by taking into account stock owned directly or indirectly through one or more residents of either treaty country.

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than the requirements that normally apply under the proposed protocol (Article IX). Specifically, to qualify for the zero rate, the dividend-receiving company must (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article with respect to dividends; or (4) receive a favorable determination from the competent authority with respect to the zero-rate provision.

According to the Technical Explanation, these additional restrictions are intended to prevent companies from reorganizing to become eligible for the zero rate. As an example, the Technical Explanation describes a situation in which a company resident in a third country that does not have a zero-rate treaty provision with the United States might contribute the stock of a wholly owned U.S. subsidiary to a wholly owned Spanish subsidiary to secure the benefit of the zero rate on a dividend from the U.S. subsidiary. In that case, the Technical Explanation explains that treaty shopping could occur notwithstanding the Spanish company's satisfaction of the active trade or business test with respect to the dividend. For this reason, the proposed protocol does not allow the benefits of the zero rate to be claimed by a company that meets only the active trade or business test of the limitation-on-benefits article.

The Technical Explanation describes the interaction of the derivative benefits test of the proposed protocol's limitation on benefits rules, the European Union's ("EU's") Parent-Subsidiary Directive, and the proposed protocol's zero withholding rate for parent-subsidiary dividends. Under the Parent-Subsidiary Directive, dividends paid by a company that is a resident of one EU country to a company that is a resident of another EU country are generally free of withholding tax in the first country. Under the proposed protocol's limitation-on-benefits rules, the Parent-Subsidiary Directive will be taken into account in determining whether the owner of a U.S. company receiving dividends from a Spanish company is an equivalent beneficiary eligible for treaty benefits under the derivative benefits rules. Thus, for example, according to the Technical Explanation, if USCo is a wholly-owned subsidiary of ICo, an Italian publicly-traded company, and USCo owns all the stock of SCo, a Spanish company, USCo will be eligible for the proposed protocol's zero withholding rate if (assuming all other applicable requirements for the zero rate are satisfied) ICo satisfies all the requirements for being an equivalent beneficiary after taking into account that dividends would be free of Spanish withholding tax under the Parent-Subsidiary Directive if paid by SCo directly to ICo.

The proposed protocol also modifies the application of the derivative benefits test under the zero-rate provision to ensure that certain joint ventures may qualify for the zero rate. Specifically, in determining whether a shareholder of a dividend-receiving company is an equivalent beneficiary, each such shareholder is treated as owning shares in the dividend-paying company with the same percentage voting power as the shares held by the dividend-receiving company for purposes of determining entitlement to the zero rate. Thus, as the Technical Explanation describes, a Spanish company owned 49 percent by a publicly-traded Spanish company and 51 percent by a publicly-traded company resident in another EU country that has an identical zero-rate provision with the United States may qualify under the derivative benefits test for the zero rate on a dividend received from a wholly-owned U.S. company even though neither shareholder of the dividend-receiving company would meet the 80-percent ownership test individually.

A zero rate of withholding tax also applies for dividends paid by a resident of one treaty country and beneficially owned by a pension fund that is a resident of the other treaty country and is generally exempt from tax or subject to a zero rate of tax, provided that the dividends are not derived from the carrying on of a trade or business, directly or indirectly, by the fund. The term "pension fund" is defined in Article 3 (General Definitions) of the treaty, as amended by Article II of the proposed protocol, described previously.

Dividends paid by U.S. RICs and REITs and similar Spanish entities

The proposed protocol includes, among other provisions of Article XIV, special rules for dividends paid by U.S. RICs and REITs and similar Spanish entities. These rules replace provisions of the 1990 protocol (paragraph 7) addressing, among other things, the taxation of dividends paid by U.S. RICs and REITs and similar Spanish entities.

The proposed protocol generally denies the five-percent and zero rates of withholding tax to dividends paid by U.S. RICs and REITs, by any Spanish entity regulated under the Law 11/2009 of 26th October on *Sociedades Anónimas Cotizadas de Inversión en el Mercado Inmobiliario* ("SOCIMI") or successor statutes, or by a Spanish investment institution regulated under the Law 35/2003 of 4th November on *Instituciones de Inversión Colectiva* or successor statutes.

The 15-percent rate of withholding generally is allowed for dividends paid by a RIC or by a Spanish investment institution regulated under the Law 35/2003 of 4th November on *Instituciones de Inversión Colectiva* or successor statutes. The zero source-country withholding rate generally available for dividends beneficially owned by a pension fund is available when the dividends are paid by a RIC or by a Spanish investment institution regulated under the Law 35/2003 of 4th November on *Instituciones de Inversión Colectiva* or successor statutes.

The 15-percent withholding rate and the zero withholding rate for dividends beneficially owned by a pension fund are available for dividends paid by a SOCIMI only if the beneficial owner of the dividends holds, directly or indirectly, capital that represents not more than 10 percent of all the capital of the SOCIMI.

The 15-percent rate of withholding and the zero rate for dividends beneficially owned by pension funds are allowed for dividends paid by a REIT, provided one of three additional conditions is met: (1) the beneficial owner of the dividends is an individual or a pension fund, in either case holding an interest of not more than 10 percent in the REIT; (2) the dividends are paid with respect to a class of stock that is publicly traded, and the beneficial owner of the dividends is a person holding an interest of not more than five percent of any class of the REIT's stock; or (3) the beneficial owner of the dividends holds an interest in the REIT of not more than 10 percent, and the REIT is diversified (that is, the value of no single interest in real property held by the REIT exceeds 10 percent of the total interests of the REIT in real property).

Definitions and special rules and limitations

The proposed protocol generally defines dividends as income from shares, "jouissance" shares or "jouissance" rights, mining shares, founders' shares, or other rights, so long as the rights are not debt claims and so long as they entitle the holder to participate in the profits of the paying company. The term "dividend" also includes income that is taxed in the same manner as income from shares under the laws of the country of residence of the paying company. Among other things, the Technical Explanation states that amounts treated as dividend equivalents under section 871(m) are dividends for purposes of the proposed protocol.

The proposed protocol's reduced rates of tax on dividends do not apply if the dividend recipient carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base in that country, and the holding in respect of which the dividends are paid is effectively connected with that permanent establishment or fixed base. In this case, the dividends are taxed as business profits (Article 7) or as income from independent personal services (Article 15).

The proposed protocol prevents each treaty country from imposing a tax on dividends paid by a resident of the other treaty country, unless the dividends are paid to a resident of the first country or the dividends are effectively connected with a permanent establishment or a fixed based situated in that first country. With an exception described below for a branch profits tax, a treaty country also may not impose tax on the undistributed profits of a company that is a resident of the other treaty country. The prohibitions just described apply even if the dividends paid or the undistributed profits consist wholly or partly of profits or income arising in the treaty country.

The proposed protocol allows each treaty country to impose a branch profits tax on a company that has income attributable to a permanent establishment in that country, derives income from real property in that country that may be taxed by that country on a net basis under the treaty, or realizes gains that may be taxed by that country under the treaty. In the case of the United States, the tax may be imposed only on the "dividend equivalent amount," consistent with the branch profits tax under U.S. internal law (section 884).

In the case of Spain, the tax may be imposed only on the amount of income *(Imposición Complementaria)* determined under the Spanish Non Residents Income Tax regulated by the Amended Text of Non Residents Income Tax Law, passed by Legislative Royal Decree 5/2004 of 5th March, as it may be amended from time to time.

The rate of branch profits tax is generally limited to five percent, but a zero rate applies where limitation-on-benefits requirements parallel to those applicable to the zero-rate provision for dividends are satisfied.

Article V. Interest

Internal taxation rules

United States

Subject to several exceptions (such as those for portfolio interest, bank deposit interest, and short-term original issue discount), the United States imposes a 30-percent withholding tax on U.S.-source interest paid to foreign persons under the same rules that apply to dividends. U.S.-source interest, for purposes of the 30-percent tax, generally is interest on the debt obligations of a U.S. person, other than a U.S. person that satisfies specified foreign business requirements. Also subject to the 30-percent tax is interest paid by the U.S. trade or business of a foreign corporation. A foreign corporation is subject to a branch-level tax on certain "excess interest" of a U.S. trade or business of that corporation. Under this rule, an amount equal to the excess of the interest deduction allowed to the U.S. business over the interest paid by the business is treated as if paid by a U.S. corporation to a foreign parent and, therefore, is subject to the 30-percent withholding tax.

Portfolio interest generally is defined as any U.S.-source interest that is not effectively connected with the conduct of a trade or business if the interest (1) is paid on an obligation that satisfies certain registration requirements, and (2) is not received by a 10-percent owner of the issuer of the obligation, taking into account shares owned by attribution. The portfolio interest exemption does not apply to certain contingent interest income.

If an investor holds an interest in a fixed pool of real estate mortgages that is a real estate mortgage interest conduit ("REMIC"), the REMIC generally is treated for U.S. tax purposes as a pass-through entity, and the investor is subject to U.S. tax on a portion of the REMIC's income (generally, interest income). If the investor holds a so-called "residual interest" in the REMIC, the Code provides that a portion of the net income of the REMIC that is taxed in the hands of the investor – referred to as the investor's "excess inclusion" – may not be offset by any net operating losses of the investor, must be treated as unrelated business income if the investor is an organization subject to the unrelated business income tax, and is not eligible for any reduction in the 30-percent rate of withholding tax (by treaty or otherwise) that would apply if the investor otherwise were eligible for such a rate reduction.

Spain

Interest derived by nonresident individuals is generally subject to withholding tax of 21 percent of the gross amount of the interest.

Proposed protocol limitations on internal law

The proposed protocol replaces Article 11 (Interest) of the 1990 treaty with a new Article 11 for interest.

The proposed protocol provides that interest arising in one treaty country (the source country) and beneficially owned by a resident of the other treaty country generally is exempt from tax in the source country. This exemption from source-country tax is similar to the rule of the U.S. Model treaty.

The proposed protocol defines interest as income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits. In particular, interest includes income from government securities and from bonds or debentures, including premiums and prizes attaching to those securities, bonds, or debentures. The term "interest" also includes all other income that is treated as income from money lent under the tax law of the treaty country in which the income arises. Interest does not include income covered in Article 10 (Dividends). Penalty charges for late payment also are not treated as interest.

The exemption from source-country taxation does not apply if the beneficial owner of the interest carries on business through a permanent establishment in the source country, or performs in the source country independent personal services from a fixed base situated in that country, and the debt-claim in respect of which the interest is paid is effectively connected with that permanent establishment or fixed base. In that circumstance, assuming the beneficial owner of the interest is a resident of one of the treaty countries, the interest is taxed as business profits (Article 7) or income from independent personal services (Article 15). According to the Technical Explanation, interest on a debt claim that is effectively connected with a permanent establishment or fixed base but that is received after the permanent establishment or fixed base is no longer in existence is taxable in the country in which the permanent establishment existed.

The proposed protocol provides a source rule for interest under which interest generally is deemed to arise in a treaty country if the payor of the interest is a resident of that country. If the person paying the interest has in a treaty country a permanent establishment or fixed base in connection with which the indebtedness on which the interest is paid was incurred, and the interest is borne by the permanent establishment or fixed base, then that interest is deemed to arise in the country in which the permanent establishment or fixed base is situated. This rule applies regardless of whether the person paying the interest is a resident of a treaty country. These source rules are not included in the U.S. Model treaty but are included in a number of other U.S. income tax treaties.

The proposed protocol addresses non-arm's-length interest charges between a payor and a beneficial owner that have a special relationship. Article 11 applies only to the amount of interest that would have been agreed in the absence of a special relationship. Any excess amount is taxable according to the laws of each treaty country, with due regard being given to other provisions of the proposed protocol. For example, according to the Technical Explanation, if the country in which the excess amount arises treats the excess amount as a distribution of profits by a corporation, that excess amount could be taxed as a dividend, subject to the source-country rate limitations of Article 10 (Dividends).

The Technical Explanation notes that the term "special relationship" is not defined in the proposed protocol and states that the United States considers the term to include the relationships

described in Article 9 (Associated Enterprises). Those relationships, according to the Technical Explanation, involve control as defined under the transfer pricing rules of section 482.

The proposed protocol provides two anti-abuse exceptions to the general source-country exemption from tax on interest arising in the United States. The first exception relates to contingent interest payments. The proposed protocol permits the United States to tax interest arising in the United States that is contingent interest and therefore does not qualify as portfolio interest under U.S. law. The rate of U.S. tax on contingent interest arising in the United States and beneficially owned by a Spanish resident may not exceed 10 percent of the gross amount of the interest. This 10-percent rate is lower than the U.S. Model treaty's maximum rate of 15 percent for contingent interest but is the same as the highest permitted source country rate of tax on interest.

The second anti-abuse exception provides that the exemption from source-country taxation does not apply to interest that is an excess inclusion with respect to a residual interest in a REMIC. The United States may tax that interest accordance with its domestic law. Article XIV of the proposed protocol replaces paragraph 8 of the 1990 protocol (addressing financial assets and income from those assets) with a new rule that defines a REMIC as an entity that has in effect an election to be treated as a REMIC under section 860D of the Code.

Relation to other Articles

The Technical Explanation notes that the benefits of Article 11, like benefits provided by other articles, are subject to the saving clause of paragraph 3 of Article 1 (General Scope) and are available only if a resident satisfies the limitation-on-benefits requirements of Article 17.

Article VI. Royalties

The proposed protocol replaces Article 12 (Royalties) of the 1990 treaty, which allowed for limited source-country taxation of royalties, with language largely following the U.S. Model treaty. It provides that royalties arising in a treaty country (the source country) and beneficially owned by a resident of the other treaty country are generally exempt from tax in the source country.

The term "royalties" as used in this article means payments of any kind received as consideration for the use of, or the right to use, any copyright of literary, artistic, or scientific work (including cinematographic films), any patent, trademark, design or model, plan, secret formula or process, or for information concerning industrial, commercial, or scientific experience. Unlike the U.S. Model treaty, the proposed protocol does not include in the term "royalties" gain from the disposition of any such property, to the extent the gain is contingent on the productivity, use, or disposition of the property. Such gains are taxable under Article 13 (Capital Gains).

The term royalties does not expressly include consideration for the use of computer software. The Technical Explanation states that consideration received for the use, or the right to use, computer software is treated either as royalties or as business profits, depending on the facts and circumstances of the transaction giving rise to the payment. The primary factor in

determining whether consideration is treated as royalties or as business profits is the nature of the rights transferred.

The exemption from source country tax does not apply if the beneficial owner of the royalties carries on a business through a permanent establishment in the source country or has performed independent personal services from a fixed base in the source country, and the right or property in respect of which the royalties are paid is effectively connected with such permanent establishment or fixed base. In that event, the royalties are taxed under Article 7 (Business Profits) or Article 15 (Independent Personal Services). According to the Technical Explanation, royalties attributable to a permanent establishment but received after the permanent establishment is no longer in existence remain taxable under the provisions of Article 7 and not under this article.

The proposed treaty addresses the issue of non-arm's-length royalties between related parties (or parties otherwise having a special relationship) by providing that this article applies only to the amount of arm's-length royalties. Any amount of royalties paid in excess of the arm's-length amount is taxable according to other provisions of the proposed treaty. For example, excess royalties paid by a subsidiary corporation to its parent corporation may be treated as a dividend under local law and therefore entitled to the benefits of Article 10 (Dividends).

Article VII. Capital Gains

The proposed protocol replaces paragraph 4 of Article 13 (Capital Gains) of the 1990 treaty, which applies to the taxation of gains from the disposition of stock, participations, or other rights in the capital or a company or other legal person. The Technical Explanation states that, under the proposed protocol, such gains are to be taxed in accordance with the general rules of Article 13. The new paragraph 4 provides that gains from the disposition of shares or other rights which directly or indirectly entitle the owner of such shares or rights to the enjoyment of immovable property (real property) situated in treaty country (the source country) may be taxed in the source country.

The proposed protocol also deletes paragraphs 6 and 7 of Article 13, so that the general rules of Article 13 apply to gains derived from the disposition of royalty-producing property (as described in the Article 12), or the right to use that property, to the extent that such gains are contingent on the productivity, use, or disposition of the property. These paragraphs are replaced with a new paragraph 6, which largely follows the language of the deleted paragraph 7 and provides that gains from the alienation of any property other than property referred to in paragraphs 1 through 5 of the Article 13 are to be taxed only in state of residence of the person alienating the property.

Article VIII. Branch Tax

The proposed protocol deletes Article 14 (Branch Tax) of the 1990 treaty. Income taxed under this article is subject to tax under the rules of Article 10 (Dividends).

Article IX. Limitation on Benefits

In general

Article IX replaces Article 17 (Limitation on Benefits) in the 1990 treaty. Under the new article, benefits that are dependent upon residency of the claimant are limited to residents who are qualified persons within the meaning of this article. Generally, the limitation operates to ensure that beneficiaries of the treaty have a sufficient nexus with a treaty country. Neither the mutual agreement procedures nor benefits to members of embassy staff, under Article 26 (Mutual Agreement Procedures) and Article 28 (Members of Diplomatic Missions and Consular Posts), respectively, are restricted by this article. The limitation-on-benefits provision includes restrictions similar to the limitations article included in the U.S. Model treaty, as well as rules developed and included in recent U.S. income tax treaties to address triangular arrangements, headquarters companies, and derivative benefits.

A resident of either treaty country, as determined under Article 4 (Residence), may satisfy the restrictions of this article in one of several ways, subject to antiabuse provisions. First, a resident who is within one of the categories enumerated in paragraph 2 of Article 17 is entitled to all benefits that are accorded by the proposed Protocol on the basis of residency. In addition, residents that do not meet one of the enumerated categories may be entitled to treaty benefits with respect to certain items of income either under the active trade or business rule or a derivative benefits rule. Third, the competent authority of one treaty country may grant treaty benefits to a resident of the other treaty country with respect to an item of income based on an evaluation of the extent to which the resident has if he determines that there is sufficient nexus to the treaty country based on an evaluation of the extent to which the various tests for entitlement to benefits were met.

Finally, anti-abuse rules govern items of income derived from one of the treaty countries by an enterprise resident in the other treaty country in so-called "triangular cases." Together, these provisions deny treaty benefits in certain cases of treaty shopping or income stripping engaged in by third-country residents. Treaty shopping may occur when residents of third countries attempt to benefit from a treaty by organizing, in a treaty country, a corporation that is entitled to the benefits of the treaty. Income stripping may result if a third-country resident eligible for favorable treatment under the tax rules of its country of residency is able to reduce the income base of a treaty country resident by having that treaty country resident pay to it, directly or indirectly, interest, royalties, or other amounts that are deductible in the treaty country from which the payments are made.

Categories of residents that qualify for all treaty benefits

The proposed protocol extends full benefits to the same categories of persons identified in the U.S. Model treaty as qualified persons: (a) an individual other than one receiving income as a nominee for, or on behalf of, a beneficial owner resident in a third-country; (b) one of the two treaty countries, or any political subdivision or instrumentality thereof; (c) a public company, or its subsidiary; (d) certain pension funds and charitable or philanthropic organizations that is established in its country of residence exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes, regardless of its tax exempt status under the

residence country's domestic law; or (e) an entity that satisfies both an ownership test and a base-erosion test. In addition to these five categories, the proposed treaty also extends full benefits to headquarters companies, that is, entities that perform headquarter functions for a multinational group of companies and are subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country with independent authority to carry out its supervisory and administrative functions. The rules to establish qualified resident status as a public company, a headquarters company or a resident who satisfies an ownership and base-erosion test are defined in greater detail in the proposed protocol, as explained below.

Public companies and subsidiaries

A company that is a resident of the United States or Spain is a qualified person entitled to all treaty benefits if it satisfies either the "regular trading test" or the "vote or value test."

1. Regular trading test

Under the regular trading test, the proposed protocol permits a company to qualify based on regular trading of the principal class of its shares, and any disproportionate class of shares, on one or more recognized stock exchanges, provided that it satisfies one of two tests, either the "primary trading test" or the "management and control test." The former requires that the company's principal class of shares is primarily traded on a recognized stock exchange in its country of residence (or in the case of a company resident in Spain, on a recognized stock exchanged located within a member state of the European Union or, in the case of a company resident in the United States, on a recognized stock exchange located in another country that is a party to the North American Free Trade Agreement ("NAFTA")). The latter test requires that the company's primary place of management and control is in its country of residence. Certain key elements of the regular trading test and its components, the primary trading test and management and control test, are described below.

a) Primarily traded

Neither the term "regularly traded" nor "primarily traded" is defined in the proposed protocol. Undefined terms used in a treaty are generally construed consistently with the domestic laws of the relevant treaty country, usually the source country. Under U.S. law, both terms are defined in the regulations promulgated to administer the branch profits tax.[45] According to the Technical Explanation, the relevant regulation[46] provides that a class of shares is regularly traded if (1) trades in the class of shares are made in more than de minimis quantities on at least 60 days during the taxable year, and (2) the aggregate number of shares in the class traded during the year is at least 10 percent of the average number of shares outstanding during

[45] Under section 884(e), a foreign corporation is exempt from the branch profits tax otherwise imposed by section 884 if it is a qualified resident of a country with which the United States has an income tax treaty. In defining "qualified resident," the Code provides a special rule for certain publicly traded corporations and their subsidiaries, permitting them to be treated as qualified residents.

[46] Treas. Reg. section 1.884-5(d)(4)(i)(B).

the year. The Technical Explanation notes that trading on one or more recognized stock exchanges in either treaty country may be aggregated for purposes of meeting the "regularly traded" requirement. In order to be considered to be primarily traded in the company's country of residence under the relevant regulatory definition of "primarily trading," the number of shares in the company's principal class of shares that are traded during the taxable year on all recognized stock exchanges in the treaty country of which the company is a resident must exceed the number of shares in the company's principal class of shares that are traded during that year on established securities markets in any other single foreign country.[47]

The term "recognized stock exchange" means the NASDAQ System owned by the National Association of Securities Dealers, Inc.; any stock exchange registered with the U.S. Securities and Exchange Commission as a national securities exchange under the U.S. Securities Exchange Act of 1934; any stock exchange controlled by the Comisión Nacional del Mercado de Valores; the stock exchanges of Amsterdam, Berlin, Budapest, Buenos Aires, Dusseldorf, Frankfurt, Hannover, London, Mexico City, Milan, Munich, Toronto and Stuttgart; and any other stock exchange agreed upon by the competent authorities of the treaty countries.

The regular trading test requires that both the principal class of shares and any disproportionate class of shares be regularly traded on one of the recognized stock exchanges. These classes of shares are defined in article 17, as follows. The "principal class of shares" is the class of ordinary or common shares of a company representing the majority of the aggregate voting power and value of that company. If the company does not have a single class of ordinary or common shares representing the majority of the aggregate voting power and value, then the term is used to refer collectively to those classes of shares that together represent a majority of the aggregate voting power and value of the company. A "disproportionate class of shares" is defined as any outstanding class of shares that is subject to terms or other arrangements that entitle a shareholder to a larger portion of the company's income, profit, or gain in the other treaty country than that to which the shareholder would be entitled in the absence of those terms or arrangements. For example, if a company resident in Spain has outstanding a class of tracking stock that pays dividends based upon a formula that approximates the company's return on its assets employed in the United States, that class of stock shall be considered a disproportionate class of shares.

b) Management and control test

If the principal class of shares of a company is regularly traded on a recognized stock exchange but does not satisfy the primarily traded test, the company may qualify for treaty benefits under the management and control test if its primary place of management and control is in the treaty country of which it is a resident. A company's primary place of management and control is located in the treaty country in which the company is a resident only if the executive officers and senior management employees exercise day-to-day responsibility for more of the strategic, financial, and operational policy decision making for the company (including direct and indirect subsidiaries) in that country than in the other treaty country or any third country, and

[47] Treas. Reg. section 1.884-5(d)(3)

if the staff that support the management in making those decisions are also based in that residence country.

The Technical Explanation notes that the management and control test should be distinguished from the "place of effective management" test used by many countries and in the OECD Model treaty to establish residence. The place of effective management test has been interpreted to mean the place where the board of directors meets. Under the proposed treaty, the place where the board of directors meets will be a necessary factor but not sufficient to establish management and control. Instead, the management and control test looks to where day-to-day responsibility for the management of the company (and its subsidiaries) is exercised.

2. Vote or value test

In an alternative to the regular trading test, companies may qualify for treaty benefits if at least 50 percent of the vote or value of its shares are owned directly or indirectly by five or fewer companies entitled to benefits under the regular trading test. A company that does not satisfy the regular trading test and either the primary trading test or the management and control test (because, for example, its shares are not publicly traded) may be entitled to treaty benefits if shares representing at least 50 percent of its aggregate voting power and value are owned, directly or indirectly, by five or fewer companies that satisfy the regular trading test and either the primary trading test or the management and control test. In order for a company to meet the vote or value test on the basis of indirect ownership, each intermediate owner must be a resident of the United States or Spain. This rule allows certain subsidiaries of publicly traded companies to be eligible for all benefits under the proposed protocol.

Ownership and base-erosion test

The ownership and base-erosion test provides a residual category under which residents not described in the other categories of residents listed in paragraph 2 may qualify for full treaty benefits. To satisfy both prongs of the test, the resident of the treaty country must establish a requisite level of ownership by residents who do qualify for treaty benefits and that at least 50 percent of its income earned remains subject to taxation in the treaty jurisdiction.

The ownership test is met if at least 50 percent of each class of the entity's shares or other beneficial interests is owned, directly or indirectly, by residents of that treaty country who are otherwise entitled to full treaty benefits under the limitation-on-benefits article without regard to the ownership and base-erosion test. The qualifying owners must be individuals, governments, public companies, pension funds, or tax-exempt organizations. In the case of indirect ownership, each intermediate owner must be a resident of the same treaty country as the entity seeking to satisfy the ownership test. In addition, the test includes a temporal requirement, in that the requisite ownership must be met on at least half the days of the taxable year of the person claiming treaty benefits under this test.

The Technical Explanation states that trusts may be entitled to the benefits of this provision if they are treated as residents under Article 4 (Residence). According to the Technical Explanation, the beneficial interests in a trust are considered to be owned by its beneficiaries in proportion to the actuarial interest of each beneficiary. For purposes of applying the ownership

test to trusts, the remainder beneficiary is considered to have an interest equal to 100 percent minus the aggregate interests determined for the income beneficiaries. An interest in a trust will not be considered to be owned by a person entitled to full treaty benefits unless the actuarial interest of the beneficiary can be determined. As a result, when an actuarial interest of any beneficiary cannot be determined, the ownership test can be satisfied only if all possible beneficiaries are persons otherwise entitled to benefits as individuals, governments, public companies, pension funds, or tax-exempt organizations.

The base-erosion test requires that less than 50 percent of the person's gross income for the taxable year, as determined in that person's country of residence, is paid or accrued, directly or indirectly, in the form of payments deductible in the person's country of residence, to persons who are not residents of either treaty country entitled to treaty benefits under this article as individuals, governments, public companies, pension funds, or tax-exempt organizations. Arm's-length payments made in the ordinary course of business for tangible property or services do not count against the entity in determining whether the threshold for base erosion is reached, nor do deductions for amortization or depreciation. According to the Technical Explanation, trust distributions that are deductible from the taxable base are deductible payments for purposes of determining whether the 50 percent threshold is reached.

Headquarters companies

Under the proposed protocol, a resident of the United States or Spain is entitled to treaty benefits if that person functions as a headquarters company for a multinational corporate group described below, whether or not it owns shares in the entities that it supervises. A potential headquarters company must perform substantial supervisory and administrative functions for a group of companies in its country of residence. The group of companies for which it performs services must operate and derive income from a genuinely multinational active business, as determined from its operations in at least five different countries, deriving gross income from each country above specified thresholds without earning excessive amounts from any one non-treaty country or from the other treaty country (that is, the treaty country in which it is not a resident). The headquarters company must be subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country, and must have independent authority in carrying out its supervisory and administrative functions. U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland include similar rules for headquarters companies, although the U.S. Model treaty does not. A person is considered a headquarters company for this purpose only if each of several criteria is satisfied.

1. Overall supervision and administration

To be considered a headquarters company, a person must provide a substantial portion of the overall supervision and administration of the multinational corporate group. This supervision and administration may include group financing, provided that group financing is not the principal activity of the company. The Technical Explanation states that a person will be considered to engage in supervision and administration only if it engages in a number of the following activities: group financing (but, as mentioned above, not as its principal activity), pricing, marketing, internal auditing, internal communications, and management. In determining

whether a substantial portion of the overall supervision and administration of the group is provided by the headquarters company, that company's headquarters-related activities must be substantial in relation to the same activities for the same group performed by other entities.

2. Genuinely multinational active trade or business

The multinational corporate group supervised by a headquarters company must consist of companies that are engaged in an active business in, and reside in, at least five countries (or five groupings of countries). The business activities carried on in each of those five countries or groupings must constitute at least 10 percent of the gross income of the group. This active trade or business rule, as well as the limitations on gross income earned in a single country or in the other treaty country, are intended to ensure that the relevant group is truly multinational. According to the Technical Explanation, the income from multiple countries may be aggregated into groupings that do not overlap in determining whether the 10-percent gross income requirement is satisfied. So long as there are either five or more individual countries or groupings that each satisfy the 10-percent requirement, the requirement is met. In addition, if the gross income requirement is not satisfied for a taxable year, it may be deemed to be met if the average gross income from the four preceding years exceeds the 10-percent gross income threshold.

The Technical Explanation gives the following example of the operation of the active trade or business requirement. SHQ is a Spanish resident that functions as a headquarters company for a group of companies resident in the United States, Canada, New Zealand, the United Kingdom, Malaysia, the Philippines, Singapore, and Indonesia. In 2012, the total gross income of the multinational corporate group is $137, of which $40 is generated in the United States, $25 in Canada, $10 in New Zealand, $30 in the United Kingdom, $10 in Malaysia, $7 in the Philippines, $10 in Singapore, and $5 in Indonesia. Ten percent of the group's gross income in 2012 is $13.70; only the United States, Canada, and the United Kingdom satisfy the 10-percent requirement by themselves. Together, the New Zealand and Malaysia members generate $20 of gross income, and the Philippines, Singapore, and Indonesia members together generate $22 of gross income. These two groupings therefore may be treated as the fourth and fifth members of the group (in addition to the United States, Canada, and the United Kingdom) under the active trade or business requirement, and the requirement is satisfied in 2012. The composition of the groupings may change from year to year. Thus, if in 2013, the income of the Canadian resident company did not exceed the 10-percent requirement but that of the New Zealand company did, Canada could be included in the fourth grouping in lieu of New Zealand to determine whether the threshold is met.

3. Single-country income limitation

The business activities carried on in any one country other than the residence country of the headquarters company may not equal or exceed 50 percent of the gross income of the group. If this less-than-50-percent requirement cannot be met for a taxable year, the taxpayer may apply the 50 percent test to the averages for the four immediately preceding years. The Technical Explanation provides an example of the application of this rule:

Example: SHQ is a corporation resident in Spain. SHQ functions as a headquarters company for a group of companies. SHQ derives dividend income from a U.S. subsidiary in the 2008 taxable year. The countries of residence of the companies in the group, the sites of their activities, and the amounts of gross income attributable to the companies for the years 2008 through 2012 are set forth below:

Country	Situs	2012	2011	2010	2009	2008
United States	U.S.	$100	$100	$95	$90	$85
Mexico	U.S.	10	8	5	0	0
Canada	U.S.	20	18	16	15	12
United Kingdom	U.K.	30	32	30	28	27
New Zealand	N.Z.	35	42	38	36	35
Japan	Japan	35	32	30	30	28
Singapore	Singapore	30	25	24	22	20
TOTAL		$260	$257	$238	$221	$207

Because the U.S. situs companies' total gross income of $130 in 2012 is not less than 50 percent of the gross income of the group, the provision is not satisfied with respect to dividends derived in 2012. However, the U.S. situs companies' average gross income for the preceding four years may be used in lieu of the preceding year's average. The United States' average gross income for the years 2008 through 2011 is $111 ($444/4). The group's total average gross income for these years is $230.75 ($923/4). Because $111 represents 48.1 percent of the group's average gross income for the years 2008 through 2011, the United States satisfies the single-country limitation.

4. Other treaty country gross income limitation

No more than 25 percent of gross income of a headquarters company that is a resident of one treaty country may be derived from the other treaty country. Thus, according to the Technical Explanation, if the headquarters company's gross income for the taxable year is $200, no more than $50 of gross income may be derived from the other treaty country. If this gross income requirement is not met for the taxable year, it may also be satisfied based on the average percentage for the four preceding years.

5. Independent discretionary authority

The headquarters company must have and exercise independent discretionary authority to carry out the overall supervision and administration functions described above for the overall supervision and administration requirement. The Technical Explanation states that this determination is made separately for each function. Thus, if a headquarters company is nominally responsible for group financing, pricing, marketing, and internal auditing functions, and another entity is actually directing the headquarters company as to the group financing function, the headquarters company would not be deemed to have independent discretionary authority for group financing, but it may have such authority for the other functions.

6. Income taxation rules

The headquarters company must be subject to the same income taxation rules in its country of residence as apply to persons who are entitled to treaty benefits with respect to certain items of income that satisfies the active business test. The Technical Explanation states that the requirement should be understood to mean that the company must be subject to the income taxation rules to which a company engaged in the active trade or business would be subject. Thus, a headquarters company is not entitled to treaty benefits under the headquarters company rules if it is subject to special taxation legislation that imposes a lower rate of income tax on headquarters companies in a treaty country than is imposed on companies engaged in the active conduct of a trade or business, or otherwise artificially lowers the taxable base for headquarters companies in the treaty country.

7. In connection with or incidental to a trade or business

The income that a headquarters company resident in one treaty country derives in the other treaty country must be derived in connection with or be incidental to the active business activities described in the special active trade or business requirement under the headquarter company rules, above. For example, according to the Technical Explanation, if a Spanish company that satisfied the other requirements of the headquarters company rules acted as a headquarters company for a group that included a U.S. company, and the group was engaged in the design and manufacture of computer software, but the U.S. company was also engaged in the design and manufacture of photocopying machines, the income that the Spanish company derived from the United States would have to be derived in connection with or be incidental to the income generated by the computer business to be entitled to treaty benefits under the headquarters company rules. The Technical Explanation similarly states that interest income received from the U.S. company also would be entitled to treaty benefits as long as the interest was attributable to the computer business supervised by the headquarters company. Interest income derived from an unrelated party, however, normally would not be considered to be in connection with or incidental to the active trade or business supervised by the headquarters company.

Certain income entitled to treaty benefits

Under the proposed protocol, residents of a treaty country that do not qualify for full treaty benefits under any of the tests described above may qualify for limited treaty benefits with respect to specific items of income under two scenarios. Active business income is entitled to treaty benefits under conditions similar to those identified in the U.S. Model treaty. In addition, income may be subject to treaty benefits under the derivative benefits rules, in which income is entitled to treaty benefits if the beneficial owners of income would have been entitled to treaty benefits they directly derived the income.

<u>Active conduct of trade or business</u>

Similar to the terms of the U.S. Model treaty, the proposed protocol permits treaty benefits for items of income connected to the active trade or business. If the income derived from the other treaty country is from a related person, the proposed protocol also imposes a

substantiality requirement for the business activities in the country of residence in relation to the activities in the source country. For purposes of determining whether income qualifies for the benefits, activities by persons related to the resident of a treaty country may be attributed to that resident. Under a Memorandum of Understanding between the Competent Authorities, executed contemporaneously with the proposed treaty, a person is deemed to be related to another person if either person or the same persons participate directly or indirectly in the management, control or capital of the other.

The term "trade or business" is not defined in the proposed protocol. According to the Technical Explanation, under paragraph 2 of Article 3 (General Definitions) of the proposed protocol, when determining whether a resident of Spain is entitled to the benefits of the proposed protocol under the active business test with respect to an item of income derived from sources within the United States, the United States will ascribe to this term the meaning that it has under the laws of the United States. Accordingly, the Technical Explanation states that the U.S. competent authority will refer to the regulations issued under section 367(a) for the definition of the term "trade or business."

In general, a trade or business will be considered to be a specific unified group of activities that constitute or could constitute an independent economic enterprise carried on for profit. The business of making or managing investments for its own account does not constitute an active trade or business unless the business of the resident is banking, insurance or securities dealing. Furthermore, a corporation generally will be considered to carry on a trade or business only if the officers and employees of the corporation conduct substantial managerial and operational activities.

The Technical Explanation elaborates on the requirement that an item of income from the source country be derived "in connection with" or be "incidental to" the resident's trade or business in its residence country. The Technical Explanation provides that an item of income is derived in connection with a trade or business if the income-producing activity in the source country is a line of business that "forms a part of" or is "complementary to" the trade or business conducted in the residence country by the income recipient.

According to the Technical Explanation, a business activity generally will be considered to form part of a business activity conducted in the source country if the two activities involve the design, manufacture, or sale of the same products or type of products, or the provision of similar services. The line of business in the country of residence may be upstream, downstream, or parallel to the activity conducted in the country of source. Thus, the line of business may provide inputs for a manufacturing process that occurs in the source country, may sell the output of that manufacturing process, or simply may sell the same sorts of products that are being sold by the trade or business carried on in the country of source.

The Technical Explanation states that for two activities to be considered to be "complementary," the activities need not relate to the same types of products or services but should be part of the same overall industry and should be related in the sense that the success or failure of one activity will tend to result in success or failure for the other. Where more than one trade or business is conducted in the country of source and only one of the trades or businesses forms a part of or is complementary to a trade or business conducted in the country of residence,

it is necessary, according to the Technical Explanation, to identify the trade or business to which an item of income is attributable. Royalties generally are considered to be derived in connection with the trade or business to which the underlying intangible property is attributable. Dividends are deemed to be derived first from earnings and profits of the treaty-benefited trade or business and then from other earnings and profits. Interest income may be allocated under any reasonable method consistently applied. A method that conforms to U.S. principles for expense allocation will be considered a reasonable method.

The Technical Explanation further states that an item of income derived from the country of source is "incidental to" the trade or business carried on in the country of residence if production of the item facilitates the conduct of the trade or business in the country of residence. An example of incidental income is the temporary investment of working capital of a person in the country of residence in securities issued by persons in the country of source.

1. Substantiality of business activity in residence country

The proposed protocol restricts the availability of the active business test by imposing a substantiality requirement if the income with respect to which treaty benefits are claimed is derived from a source related to the claimant. In such instances, the income qualifies for treaty benefits only if the trade or business activity in the residence country is substantial in relation to the trade or business activity conducted by the related entity in the source country. According to the Technical Explanation, by limiting the substantiality requirement to transactions between related parties, the provision thwarts treaty-shopping abuses in which a company attempts to qualify for benefits by engaging in minor business activities in its jurisdiction of residence that are of little economic cost or effect for the company as a whole, without hindering activity that is not potentially abusive.

Whether the substantiality requirement is met is determined separately for each item of income derived from the source country on the basis of all the facts and circumstances. Facts and circumstances relevant to the determination of substantiality include the comparative sizes of the trades or businesses in each treaty country, the nature of the activities performed in each country, and the relative contributions made to that trade or business in each country. Thus, it is possible that income from one line of business may qualify for favorable treatment under the proposed protocol, but income from another activity in the source country is ineligible.

2. Attribution rules

The proposed protocol provides attribution rules to be used in determining whether a person is engaged in the active conduct of a trade or business in a treaty country and whether it is subject to the substantiality requirement. Activities conducted by persons connected to the person claiming treaty benefits will be deemed to be conducted by that person. A person is "connected" to another person if one person possesses at least 50 percent of the beneficial interest in the other (or, in the case of a company, at least 50 percent of the aggregate voting power and at least 50 percent of the aggregate value of the shares in the company or of the beneficial equity interest in the company). Alternatively, a connection between entities exists if the entities are under common ownership, that is, one owner holds the requisite 50-percent interest in each of the entities. Regardless of the formalities of ownership, person may be

considered to be connected to one another if, based on all the relevant facts and circumstances, one has control of the other or both are under the control of the same person or persons.

Derivative benefits rule

The proposed protocol includes derivative benefits rules that are generally intended to allow a treaty-country company treaty benefits for an item of income if the company's owners would have been entitled to the same benefits for the income had those owners derived the income directly. Under these derivative benefits rules, a treaty-country company is eligible for treaty benefits for an item of income only if the company satisfies both an ownership requirement and a base-erosion requirement.

1. Ownership test

A company satisfies the ownership requirement if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. In the case of indirect ownership, each of the indirect owners must be a resident of either a member state of the European Union or a party to NAFTA. The term "disproportionate class of shares" has the same definition as previously described.

An equivalent beneficiary must be a resident of a country that is either an EU member country or a party to NAFTA (together, "qualifying countries") and must satisfy either of two criteria. The first criterion includes two requirements. First, the person must be entitled to all treaty benefits under a comprehensive income tax treaty between a qualifying country and the country from which the benefits of the U.S.-Spain treaty are being claimed (an "applicable treaty"), and this entitlement to treaty benefits must result from satisfaction of limitation-on-benefits provisions analogous to the proposed protocol's rules, described above, for individuals, governments, publicly-traded companies, pension funds, and tax-exempt organizations. If the applicable treaty does not include a comprehensive limitation-on-benefits article, this first requirement is satisfied only if the person would meet the proposed protocol's requirements for entitlement to treaty benefits as an individual, a government, a publicly-traded company, a tax-exempt organization, or a pension fund. Second, for income from dividends, interest, or royalties, the person must be entitled under an applicable treaty to a rate of tax on that income that is at least as low as the rate applicable under the proposed protocol.

For dividend, interest, or royalty payments arising in Spain and beneficially owned by a resident of the United States, the proposed protocol includes a special rule for determining whether a company that is a resident of an EU member country satisfies the tax rate test for purposes of determining whether the U.S. resident is entitled to treaty benefits for the payments. The special rule provides that the EU member country resident satisfies the tax rate test if a dividend, interest, or royalty payment arising in Spain and paid directly to that EU member country resident would be exempt from withholding tax under an EU directive even though the income tax treaty between Spain and that EU member country would permit imposition of a higher withholding tax rate on that payment than is permitted by the proposed protocol. The Technical Explanation states that this special rule takes into account that withholding taxes on many intercompany dividend, interest, and royalty payments are exempt within the European

Union under various EU directives. The special rule is necessary, according to the Technical Explanation, because many EU member countries have not renegotiated their tax treaties to reflect the elimination of withholding tax under the EU directives.

Under the second criterion for determining whether a resident of a qualifying country is an equivalent beneficiary, the resident must be a U.S. or Spanish resident that is entitled to treaty benefits under one of the rules described previously for individuals, governments, publicly traded companies, pension funds, and tax-exempt organizations. Under this rule, according to the Technical Explanation, a Spanish individual is an equivalent beneficiary for an item of income received by another treaty country resident regardless of whether the individual would have been entitled to receive the same benefits if it had received the income directly. The Technical Explanation states that this criterion is included to clarify that ownership by certain residents of a treaty country does not disqualify a U.S. or Spanish company from treaty benefits under the derivative benefits rules. If, for example, 90 percent of a Spanish company is owned by five companies that are residents of EU member countries and that satisfy the first criterion described above, and 10 percent of the Spanish company is owned by a U.S. or a Spanish individual, the Spanish company still can satisfy the requirements of the ownership test of the derivative benefits rules.

2. Base-erosion test

A company satisfies the base-erosion requirement for an item of income only if, in the taxable year in which the income item arises, the amount of the deductible payments or accruals the company makes, directly or indirectly, to persons who are not equivalent beneficiaries is less than 50 percent of the company's gross income for the year, as determined in the company's country of residence. Deductible payments do not include arm's-length payments in the ordinary course of a business for services or tangible property. The Technical Explanation notes that the base-erosion requirement under the derivative benefits rule is the same as the base-erosion test described previously (that is, the test that is included in the rules for determining whether a treaty country resident has one of the six attributes for qualification for all treaty benefits), except that, for the derivative benefits rule, deductible payments made to equivalent beneficiaries, not just to residents of a treaty country entitled to treaty benefits, are excluded from the payments that count toward the 50-percent limitation.

Anti-abuse rules: The triangular case

The proposed protocol provides a special anti-abuse rule that, according to the Technical Explanation, addresses a Spanish resident's use of the following structure to earn interest income from the United States. The Spanish resident (who is otherwise qualified for benefits under this article) organizes a permanent establishment in a third country that imposes a low rate of tax on the income of the permanent establishment. The Spanish resident then lends funds into the United States through the permanent establishment. The permanent establishment is an integral part of the Spanish resident. Consequently, the interest income that the permanent establishment earns on the loan is entitled to exemption from U.S. withholding tax under the treaty. Under the tax treaty between Spain and the third country, Spain does not tax the income earned by the permanent establishment. Alternatively, Spain may choose to exempt the income of the

permanent establishment from Spanish income tax. Consequently, the income is not taxed in Spain or the United States, and is only lightly taxed in the third country.

Under the proposed protocol, the United States may impose withholding tax on the interest payments if the combined tax actually paid on the income in Spain and the third country is less than 60 percent of the general rate of company tax applicable in Spain.

Although the example in the Technical Explanation involves interest income, the triangular provision applies to all types of income. Any dividends, interest, or royalties to which the provision applies may be subject to a maximum withholding tax rate of 15 percent. Any other income to which the provision applies is subject to tax under the domestic law of the source country, notwithstanding any other provision of the proposed protocol.

According to the Technical Explanation, the principles of the U.S. subpart F rules are employed to determine whether the profits of the permanent establishment are subject to an effective rate of tax that is above the specified threshold.

The triangular provision does not apply to royalties that are received as compensation for the use of, or the right to use, intangible property produced or developed by the permanent establishment itself. In the case of any other income, the triangular provision does not apply if that income is derived in connection with, or is incidental to, the active conduct of a trade or business carried on by the permanent establishment in the third country. Making, managing, or holding investments for the person's own account does not qualify for this active conduct exception unless these activities are carried on by a registered securities dealer.

The triangular provision applies reciprocally. However, the United States does not exempt the income of a third-country permanent establishment of a U.S. resident from U.S. tax, either by statute or by treaty.

Grant of treaty benefits by the competent authority

Under the proposed protocol, a resident of a treaty country that is not otherwise entitled to treaty benefits in the other treaty country under this article may nonetheless be granted treaty benefits by the competent authority of the other treaty country. The competent authority may grant full or partial treaty benefits based on an evaluation of the extent to which the resident of the other country met any of the criteria under other provisions in the article. The competent authority of the source country is required to consider the views of the competent authority of the residence country in determining whether to extend treaty benefits under this provision.

Article X. Pensions, Annuities, Alimony, and Child Support

This article of the proposed protocol adds new paragraph 5 to Article 20 (Pensions, Annuities, Alimony, and Child Support) of the 1990 treaty.

The new paragraph provides that, if a resident of one treaty country is a member or beneficiary of, or participant in, a pension fund that is a resident of the other treaty country, income earned by the pension fund may be taxed as income of that individual only when the income is distributed. Thus, for example, if a U.S. citizen contributes to a U.S. qualified plan

while working in the United States and then establishes residence in Spain, the new paragraph prevents Spain from taxing currently the plan's earnings and accretions with respect to that individual. When the resident receives a distribution from the pension fund, that distribution may be subject to tax in the treaty country where the individual is resident, subject to paragraph 1 of Article 20.

Article XI. Non-Discrimination

Under the proposed protocol, the rules for branch taxes are revised and moved to paragraph 8 of Article 10 (Dividends). The proposed protocol makes a conforming change to paragraph 3 of Article 25 (Non-Discrimination) of the 1990 treaty. Under the proposed protocol, this paragraph 3 clarifies that nothing in Article 25 may be construed as preventing either the United States or Spain from imposing a branch tax described in paragraph 8 of Article 10 (Dividends).

Article XII. Mutual Agreement Procedure

Article 26 (Mutual Agreement Procedure) of the 1990 treaty allows taxpayers to bring to the attention of the competent authorities problems under the treaty and authorizes the competent authorities of the two countries to cooperate to resolve disputes, clarify issues, and address cases of double taxation not provided for in the treaty. The taxpayer who presents such a matter ("the presenter") to one of the competent authorities must do so within five years of the first notification of the action that resulted in taxation not in accordance with the treaty. The proposed protocol amends the 1990 protocol provision that defined the term "first notification of action" and provides that for the United States, it is a notice of proposed adjustment and for Spain it is a Notice of Administrative Act of Assessment. For matters involving collection of tax at the source, the first notification of action for both countries is the date on which tax is withheld or paid.

The proposed protocol adds rules for mandatory and binding arbitration for certain cases about which the competent authorities cannot reach a negotiated agreement. A mandatory and binding arbitration procedure is not included in the U.S. Model treaty, but has recently been included in the U.S. income tax treaties with Belgium, Canada, Germany and France. In general, the new rules mandate resolution through arbitration of any case initiated under the mutual agreement procedure if the competent authorities have tried but are unable to reach a complete agreement within two years of the commencement date of the case. The requirements, conditions and procedures for such arbitration are detailed in new paragraphs 5 and 6 of Article 26, as well as in amendments to the 1990 protocol that are made in Article XIV of the proposed protocol.

New paragraph 5 of Article 26 identifies the following threshold conditions for determining that a case is ripe for opening a mandatory arbitration proceeding. The case must be limited to taxable years for which tax returns were filed with at least one of the treaty countries; the competent authorities have not preempted the case by agreeing that the case is not suitable for determination by arbitration, prior to the date on which arbitration proceedings otherwise would have begun; no court or administrative body in either treaty country has rendered a decision with respect to the case; and the case does not involve a determination of residence of a

company under Article 4 (Residence). The foregoing conditions generally establish whether a case is of a type appropriate for arbitration. The final condition in paragraph 5 requires that the starting date of an arbitration proceeding must satisfy the requirements of paragraph 6(c).

The commencement of arbitration must comport with the conditions of subparagraph 6(c) for determining a beginning date. The arbitration proceeding shall begin on the later of (1) two years after the commencement date of the mutual agreement procedure case, unless both competent authorities previously have agreed to a different date, (2) the date upon which the presenter of the case requests arbitration, (3) the date on which all concerned persons and representatives have submitted signed confidentiality agreements described below, or (4) the date on which any related legal actions or suits pending before a court in either treaty country are suspended or stayed. The proposed protocol defines the commencement date of a case to be the earliest date on which both competent authorities have received the information necessary to undertake substantive consideration for a mutual agreement. The proposed protocol also defines concerned person to include the presenter of the case as well as any other persons whose tax liability to either treaty country may be directly affected by a mutual agreement arising from that consideration.

According to the Technical Explanation, the competent authorities may exercise the authority to agree to postpone or accelerate the first described date above, that is, the date other than two years after the commencement date, when appropriate to manage caseloads and resources of the competent authorities. For example, a case in which negotiations have been productive and are nearing completion may not be capable of being completed within the two year period due to the complexity of final computations necessary for resolution. In such cases, the competent authorities could agree to consider a different date as a means of extending the time available in which to resolve the case without necessitating arbitration. Notice of the decision to extend or accelerate the date must be provided to the presenter.

In addition, prior to the initiation of any arbitration proceedings between the two countries, the competent authorities must agree in writing upon various procedures and timetables to be applicable in all arbitration proceedings. According to the Technical Explanation, the agreed upon procedures and interpretations are to be made available in the form of published guidance before the date that the first arbitration proceeding begins. Matters on which the competent authorities must agree include the date on which notice is given to the presenter of any agreement by the competent authorities that the case is unsuitable for arbitration, the deadline for obtaining the necessary confidentiality agreements, the dates and procedures for submissions to the arbitration panel, responses to such submissions, the dates and procedures for delivery of the determination by the arbitration panel, and any response by the presenter to the determination.

The confidentiality agreement from the presenter and concerned persons must provide that the signatories will not disclose to any other person any information, other than the determination of the arbitration board, received during the course of the arbitration proceeding from either treaty country or the arbitration board. The Technical Explanation states that the confidentiality agreement may be executed by any concerned person that has legal authority to bind any other concerned person on the matter. For example, according to the Technical

Explanation, a parent corporation with the legal authority to bind its subsidiary to keeping information confidential may execute a confidentiality agreement for itself and its subsidiary.

The proposed protocol also includes confidentiality rules for arbitration board members and staff and for the competent authorities. Those individuals may not disclose information relating to an arbitration proceeding (including the board's determination) unless disclosure is permitted by the treaty and the domestic laws of the United States and Spain. According to the proposed protocol, all material prepared in the course of or relating to an arbitration proceeding is considered information exchanged between treaty countries. All members of the arbitration board and their staffs must send to each country statements in which they agree to abide by and be subject to the confidentiality and nondisclosure requirements of the treaty's exchange of information article and the applicable domestic laws of each country. If any of those provisions conflict, the most restrictive provision applies.

New paragraph 21 of the 1990 protocol, as amended by Article XIV of the proposed protocol describes the procedures for selection of a three-person arbitration panel, the form and manner in which submissions are made to the panel, and the form and manner of determinations of the panel and consequences of the issuance of a determination. It also provides for equitable sharing of all expenses of conducting an arbitration proceeding.

Each competent authority may select one member, and the two members selected by the competent authorities select the third member, who serves as chair of the panel. Failure to agree upon selection of a third member will result in the dismissal of the first two members and require that each competent authority select a new member of the panel. No one who was an employee of the tax administration, the U.S. Treasury Department or the Ministry of Finance within a year prior to the beginning of the arbitration proceeding is eligible to be appointed to the panel. Citizens, residents or nationals of either treaty country are ineligible to serve as the chair of the arbitration panel. The proposed protocol provides that the arbitration board may adopt any procedures necessary for the conduct of its business so long as the procedures are not inconsistent with any other provisions of Article 26.

Each competent authority is permitted to make a submission to the arbitration panel, consisting of a proposed resolution of each issue in the case and a supporting position paper. A copy of that submission is also made available to the other competent authority, who may provide a written response. The proposed resolution describes the proposed disposition of the specific amounts of income, expense, or taxation at issue in the case, but to the extent that multiple issues are under consideration, and the resolution of one issue is contingent on the resolution of another, the competent authority may submit proposed resolutions that address alternative outcomes.

The presenter of the case to the competent authority of a treaty country is also permitted to submit a written analysis and views to the panel. According to the Technical Explanation, this submission does not include a specific resolution like that required of the treaty countries. The submission must be limited to information previously provided to the competent authorities as part of the mutual agreement procedure. The submissions made by the competent authorities are not provided to the presenter.

The procedures specify conditions under which an arbitration proceeding may be terminated after it has begun. If no determination has been reached by the panel, the proceeding is terminated if the competent authorities agree to resolve the case and terminate the proceeding, the presenter withdraws the request that the competent authorities engage in the mutual agreement procedures, or a concerned person initiates legal action in either treaty country and the proceeding is not suspected in that country under domestic law. In addition, the proceeding may be terminated upon agreement of the competent authorities if a concerned person commits a willful violation of the disclosure provisions.

The determination of the arbitration board is limited to a conclusion about the amount of income, expense, or tax reportable to the treaty countries. In its determination resolving the case, the arbitration panel must select one of the proposed resolutions submitted by the treaty countries. The determination may not state a rationale and is intended to have no precedential value. Unless otherwise agreed by the competent authorities, the presenter has 45 days from receipt of the panel's determination to advise the competent authority of his acceptance of the determination. Failure to respond within that time is deemed to be rejection of the determination of the arbitration panel. In addition, if the case is in litigation, any concerned person who is a party to the litigation must also advise, within the same time period, the relevant court of its acceptance of the determination of the arbitration panel as the resolution by mutual agreement and withdraw from the consideration of the court the issues resolved through the arbitration. Failure to do so is considered a rejection of the determination by the presenter. Any case in which the determination of the arbitration panel is not accepted is not eligible for further consideration under the mutual agreement procedure.

The competent authorities of the treaty countries may modify or supplement the rules and procedures provided in the proposed protocol to the extent necessary to better implement the intent of mandatory arbitration to eliminate double taxation.

Article XIII. Exchange of Information and Administrative Assistance

The proposed protocol replaces Article 27 in the existing treaty with rules governing exchange of information and administrative assistance that are substantially similar to those in the U.S. Model treaty. The description below explains the scope and operation of the individual paragraphs. It also identifies instances in which the article varies from the U.S. Model treaty.

The United States and Spain agree to exchange such information as is foreseeably relevant in carrying out the provisions of the proposed protocol or in carrying out the provisions of the domestic laws of the two treaty countries concerning all taxes of any kind imposed by a treaty country. The use of the word "relevant" indicates the breadth of the scope of the exchanges, in establishing the standard for determining whether or not information may be exchanged under the proposed protocol. It conforms to the standard used in section 7602, which is the principal source of authority for U.S. information gathering and examination of records. Under section 7602, the IRS may request to examine any books, records or other material that

"may be relevant," as confirmed by the U.S. Supreme Court in a line of cases beginning with *United States v. Powell.*[48]

In the United States, the administrative authority of the IRS to obtain information by service of an administrative summons extends to the territories and possessions under section 7651 in the same manner as if the possession or territory were a state. Thus, even though paragraph 1(a) of Article 3 (General Definitions) of the proposed protocol provides a definition of "United States" that limits its meaning to its geographic sense for most purposes under the proposed protocol and specifically carves out its possessions and territories, information in the U.S. possessions or territories is subject to exchange of information pursuant to a proper request under the proposed protocol.

Information may be exchanged to enable each treaty country to administer its own domestic law, to the extent that taxation under that law is not contrary to the proposed protocol. The competent authority of one treaty country may request information about a transaction from the competent authority of the other treaty country even if the transaction to which the information relates is a purely domestic transaction in the requested country and information exchange about the transaction would not be undertaken to carry out the proposed protocol. As an example, similar to the rules applicable under the OECD Model treaty, if a U.S. company and a Spanish company transact with one another through a company resident in a third country that has no treaty with the United States or Spain, the U.S. and Spanish competent authorities may, to enforce their internal rules, exchange information about prices their respective resident companies paid in their transactions with the third-country company.

The proposed protocol provides that exchange of information may include information relating to the assessment or enforcement of taxes of any kind. Enforcement includes the collection of, or prosecution in respect of, or the determination of appeals in relation to, taxes. Consequently, the competent authorities may exchange information about collection cases, cases under civil examination or criminal investigation, and cases being prosecuted.

Exchange of information is not restricted by paragraph 1 of Article 1 (General Scope) or Article 2 (Taxes Covered). Accordingly, information about persons who are residents of neither Spain nor the United States may be requested and provided under this article. For example, if a third-country resident has a Spanish bank account and the IRS believes that funds in the account should have been, but have not been, reported, the U.S. competent authority may request information from Spain about the bank account. Similarly, the competent authorities may exchange information relating to a broader category of taxes beyond those otherwise covered by the proposed protocol, including, for example, U.S. estate and gift taxes, U.S. excise taxes, and Spanish value-added taxes.

Under paragraph 2, any information exchanged under the proposed protocol is to be treated as secret in the same manner as information obtained under the domestic laws of the treaty country receiving the information. Failure to comply with the conditions of confidentiality may result in suspension of further exchanges of information. According to the Technical

[48] 379 U.S. 48 (1964).

Explanation, a Competent Authority who determines that information provided by his tax administration has been the subject of a breach of secrecy may suspend all further exchanges until he receives proper assurances that confidentiality will be respected. The discretion to enter into a memorandum of understanding may be used to implement special arrangements regarding confidentiality safeguards.

The exchanged information may be disclosed only to persons or authorities (including courts, administrative bodies, and legislative bodies) involved in the administration, enforcement or oversight of the tax laws. Such functions include assessment, collection, civil and criminal prosecution, and the determination of appeals in relation to the taxes to which the proposed protocol applies. The paragraph also authorizes disclosure of the exchanged information to persons involved in oversight of taxes, which in the United States includes the tax-writing committees of the U.S. Congress and the Government Accountability Office. Such persons or authorities receiving the information may use the information only in the performance of their role in overseeing the administration of U.S. tax laws. Exchanged information may be disclosed in public court proceedings or in judicial decisions. Finally, disclosure and use of the exchanged information for purposes consistent with a mutual legal assistance treaty in force between the United States and Spain is permitted if the competent authority for the country that provided the information to be disclosed or used has consented in writing.

The proposed protocol includes protections against requiring a treaty country to take action contrary to its own laws while ensuring that such protection is not used to refuse a proper request simply because the requested country does not have an domestic tax need for the information. Paragraph 3 of the new Article 27 specifies that a treaty country is not required to carry out administrative measures at variance with the laws and administrative practice of either treaty country, to supply information that is not obtainable under the laws or in the normal administrative practice of either treaty country, or to supply information that would disclose any trade, business, industrial, commercial, or professional secret or trade process, or information the disclosure of which would be contrary to public policy. Paragraph 4 provides that the requested treaty country is required to exercise its administrative powers to obtain information even if it is not needed or usable in a domestic tax matter and specifies that the restrictions in paragraph 3 do not justify a refusal to exchange of information based on lack of a domestic interest.

This provision makes clear that the restrictions discussed above do not permit rejection of a request based solely on its lack of relevance under domestic law of the requested country. If information requested by a treaty country is within the scope of this article, the proposed protocol provides that the requested treaty country must obtain the information in the same manner and to the same extent as if the tax of the requesting treaty country were the tax of the requested treaty country and were being imposed by that treaty country. The request for exchange of information is to be honored notwithstanding that the requested treaty country may not need the information at that time for purposes of administering its own tax rules. Thus, for example, if a treaty country is asked to provide information, it should provide the information even if its own statute of limitations period has expired for the issue to which the information relates. The statute of limitations of the treaty country making the request should govern.

According to the Technical Explanation, even in cases in which the restrictions on information exchange are appropriately construed to relieve a treaty country of an obligation to

supply information in response to a request from the other treaty country, the requested country may choose to supply the information if doing so does not violate its internal law. The limitations on the scope of the obligation to exchange information do not preclude exchange.

The proposed protocol at paragraph 5 explicitly limits the scope of the general principle described above that the treaty is not intended to require any actions by a treaty country at variance with its domestic law, by providing that a treaty country cannot refuse to respond to a request for information based on the fact that the information is in the possession of financial institutions, nominees, or persons acting in an agency or fiduciary capacity. With regard to persons acting in an agency or fiduciary capacity, the scope of any override of domestic law is not clear. Thus, a competent authority receiving a request for information from a financial institution may not decline the request based on an argument that domestic bank secrecy or similar rules override the proposed protocol obligations and preclude honoring the request.

The proposed protocol at paragraph 5 also provides that the competent authorities shall not refuse to exchange information because it relates to information concerning ownership interests in a "person." According to the Technical Explanation, this requirement is expected to have the effect of requiring disclosure of the beneficial owner of bearer shares, notwithstanding the lack of reference to ownership interests in instruments as well as persons.

The proposed protocol makes it possible for a treaty country to request that responsive information be provided in an authenticated form that will facilitate use of that information in the administrative or judicial proceedings in the requesting treaty country. Upon specific request by the competent authority of a treaty country, the other treaty country competent authority must provide information in the form of depositions of witnesses and authenticated copies of unedited original documents (including books, papers, statements, records, accounts, and writings), to the same extent such depositions and documents can be obtained under the laws and administrative practices of the requested treaty country with respect to its own taxes.

The proposed protocol includes agreement to provide administrative assistance in collection to the extent needed to ensure that reduced withholding rates and exemptions granted by the treaty are not used by persons not entitled to such benefits. Unlike the exchange of information, the authority to provide collection assistance is limited by to taxes covered by the treaty as described in Article 2 (Taxes Covered). The provision does not obligate either treaty country to act at variance with laws or practices applicable to its administration of its domestic tax law. The Technical Explanation provides an example of a payment of a portfolio dividend from a U.S. withholding agent, who withholds at the portfolio dividend rate of 15 percent, in reliance on a Form W-8BEN that lists an addressee in Spain. If the IRS determines that the addressee was acting as a nominee on behalf of a third-country resident, Spain would be obligated to assist the United States in recovering the addition tax that the U.S. withholding agent should have collected.

Upon entry into force of the proposed protocol, the exchange of information provision in is applicable to any taxable period, including taxable periods prior to the entry into force (Article XV of this proposed protocol). If the provisions of the new Article 27 are subsequently terminated in accordance with Article 30 (Termination) of the existing treaty, authority to exchange information with respect to any taxable period would cease under the treaty.

According to the Technical Explanation, the competent authorities could exchange information to the extent that domestic law or another international agreement permitted such exchange.

Article XIV. Other Amendments

Article XIV of the proposed protocol amends certain provisions of the 1990 protocol.

Paragraph 1 of Article XIV deletes subparagraph 5(b) of the 1990 protocol, which establishes residence rules for partnerships, estates, and trusts. The new rules are contained in new paragraph 6 of Article 1 (General Scope), pursuant to Article I of the proposed protocol. In addition, subparagraph 5(c) of the 1990 protocol is renamed subparagraph 5(b).

Paragraph 2 of Article XIV replaces paragraph 7 of the 1990 protocol, which includes certain rules for the taxation of dividends, including dividends paid by U.S. RICs and REITs and by similar Spanish entities, with new rules related to dividends paid by RICs, REITs, and similar Spanish entities. These new rules are described previously in the description of Article IV (Dividends).

Paragraph 3 of Article XIV replaces paragraph 8 of the 1990 protocol with a rule defining the term real estate mortgage investment conduit. That definition is described previously in the description of Article V (Interest).

Paragraph 4 of Article XIV deletes subparagraph 10(c) of the 1990 protocol as a conforming change to the amendments made to Article 13 (Capital Gains) of the 1990 treaty, pursuant to Article VII of the proposed protocol.

Paragraph 5 of Article XIV deletes paragraph 11 of the 1990 protocol as a conforming change to the deletion of Article 14 (Branch Tax) of the 1990 protocol, pursuant to Article VIII of the proposed protocol.

Paragraph 6 of Article XIV deletes paragraph 12 of the 1990 protocol, which concerns the term "fixed base" as referenced in Article 15 (Independent Personal Services) of the 1990 treaty. According to the Technical Explanation, the deletion ensures that Article 14 (Independent Personal Services) can be interpreted in a manner consistent with the prevailing Commentaries of the OECD Model treaty.

Paragraph 7 of Article XIV amends paragraph 13 of the 1990 protocol, which concerns certain organizations described in Article 17 (Limitations on Benefits), by deleting the words "tax-exempt" to conform to Spanish domestic law, and replacing the reference to "paragraph 1(d)" with the phrase "clause (ii) of subparagraph (d) of paragraph 2" to conform to the structure of Article 17 as amended by the proposed protocol.

Paragraph 8 of Article XIV replaces paragraph 18 of the 1990 protocol, which deals with Article 26 (Mutual Agreement Procedure). The new paragraph 18 is described previously in the description of Article XII (Mutual Agreement Procedure).

Paragraph 9 of Article XIV deletes paragraph 19 of the 1990 protocol, which deals with Article 27 (Exchange of Information and Administrative Assistance) in the 1990 treaty and

specifies a particular version of the Commentaries on the OECD Model treaty. Removal of the provision ensures that interpretation of Article 17 (Exchange of Information and Administrative Assistance) will be consistent with the prevailing OECD Commentaries, as intended by the treaty countries.

Paragraph 10 of Article XIV adds a new paragraph to the 1990 protocol, dealing with Article 26 (Mutual Agreement Procedure). The substance of this provision is explained previously in the description of Article XII (Mutual Agreement Procedure).

Article XV. Entry into Force

This Article contains rules for bringing the proposed protocol into force and giving effect to its provisions. The Memorandum of Understanding enters into force on the date of entry into force of the proposed protocol.

The proposed protocol is subject to ratification in accordance with the applicable procedures in the United States and Spain. The treaty countries shall notify each other in writing, through diplomatic channels, when their respective applicable procedures have been satisfied. The proposed protocol will enter into force three months following the date of the later of the notifications. The date the proposed protocol enters into force is not necessarily the date on which its provisions take effect.

With respect to withholding taxes (principally on dividends, interest, and royalties), the proposed protocol has effect for amounts paid or credited on or after the date on which the proposed protocol enters into force. The Technical Explanation provides an example, in which, as a result of the instruments of ratification being exchanged on April 25 of a given year, the treaty rate of withholding specified in new Article 11 of the treaty, as amended by Article V of the proposed protocol, is applicable to any interest paid or accrued after July 25 of that year.

With respect to taxes determined with reference to a taxable period, the proposed protocol has effect for taxable periods beginning on or after the date on which the proposed protocol enters into force.

In all other cases, the proposed protocol has effect on or after the date on which the proposed protocol enters into force.

The proposed protocol sets forth additional rules regarding the applicability of the mandatory binding arbitration rules of Article 26 (Mutual Agreement Procedure) of the treaty, as amended by Article XII of the proposed protocol. These rules will not have effect with respect to cases that are under consideration by the competent authorities of the treaty countries on the date on which the proposed protocol enters into force. For cases that come under consideration by the competent authorities of the treaty countries after the date on which the proposed protocol enters into force, these rules have effect on the date on which the competent authorities agree in writing on a mode of application pursuant to subparagraph (g) of paragraph 6 of Article 26. For cases that come under consideration by the competent authorities that come under consideration by the competent authorities of the treaty countries after the entry into force of the proposed protocol, but before such provisions have effect, the commencement date will be the date on which the competent authorities have agreed in writing on the mode of application.

Memorandum of Understanding

Contemporaneously with the signing of the proposed protocol, the United States and Spain signed a Memorandum of Understanding related to a number of provisions of the treaty.

Paragraph 2 of the Memorandum of Understanding commits the United States and Spain to initiate discussions as soon as possible, but no later than six months after the proposed protocol enters into force, regarding the conclusion of an appropriate agreement to avoid double taxation on investment between Puerto Rico and Spain. This commitment follows the agreement between the United States and Spain, in paragraph 3 of the 1990 protocol, to initiate, as soon as possible, the negotiation of a protocol to extend the application of the treaty to Puerto Rico, taking into account the special features of the taxes applied by Puerto Rico.

Paragraph 4 of the Memorandum of Understanding states that the principles of paragraph 8.6 of the Commentaries to the OECD Model treaty should apply in determining the residence of pension funds and organizations established and maintained in a treaty country exclusively for religious, charitable, scientific, artistic, cultural, or educational purposes. Paragraph 8.6 of the Commentaries discusses how a person, such as a pension fund, may be liable to tax in a treaty country, and therefore considered a resident of that country, even though that country does not in fact impose a tax on that person.

The remaining paragraphs 1, 3 and 5 in the Memorandum of Understanding are addressed in the foregoing descriptions of Articles I (General Scope), II (General Definitions) and IX (Limitations on Benefits) of the proposed protocol, respectively.

VI. ISSUES

A. U.S. Model Treaty as a Reflection of U.S. Tax Policy

The current U.S. Model treaty was published in 2006. A number of U.S. income tax treaties and protocols to earlier treaties have entered into force since then. Significant deviations from the U.S. Model treaty have, understandably, proliferated. This proliferation can be expected to continue as the U.S. State Department and Treasury Department negotiate new income tax treaties and protocols.

The proposed protocol includes at least three provisions, the limitation on benefits rules, mandatory binding arbitration rules, and the zero rate of withholding on parent-subsidiary dividends, that include or represent important deviations from the U.S. Model treaty. The Committee may wish to consider, among other questions described below, the extent to which these deviations represent actual U.S. income tax treaty policy notwithstanding that they differ from the policy as provided in the U.S. Model treaty. The Committee also may wish to inquire into whether the Treasury Department expects to publish a new model treaty in the near future and, if it does so expect, whether that new model would include provisions similar to the three deviations described below

1. Limitation on Benefits

In general

The proposed protocol, like nearly all U.S. income tax treaties, generally limits treaty benefits for treaty country residents so that only those residents with a sufficient nexus to a treaty country will receive treaty benefits. Although the proposed protocol generally is intended to benefit residents of Spain and the United States only, residents of third countries sometimes attempt to use a treaty to obtain treaty benefits. This practice is known as treaty shopping. Investors from countries that do not have tax treaties with the United States, or from countries that have not agreed in their tax treaties with the United States to limit source-country taxation to the same extent that it is limited in another treaty may, for example, attempt to reduce the tax on interest on a loan to a U.S. person by lending money to the U.S. person indirectly through a country whose treaty with the United States provides a lower rate of withholding tax on interest. The third-country investor may attempt to accomplish this result by establishing in that treaty country a subsidiary, trust, or other entity that then makes the loan to the U.S. person and claims the treaty reduction for the interest it receives – a reduction in withholding tax that would not have been possible had the investor made the loan directly from his or her country of residence.

Although the rules imposing a limitation on benefits in the proposed protocol are similar to the rules in other recent and proposed U.S. income tax treaties and protocols and in the U.S. Model treaty, they are not identical. The Committee may wish to inquire about certain differences such as the inclusion of full treaty benefits for headquarters companies, the derivative benefits rule and the anti-abuse rules on certain triangular arrangements, as well as selected aspects of applying the rules with respect to publicly traded companies. In addition, the Committee may wish to inquire about the standard that is to be applied by competent authorities

in exercising discretion to grant benefits to a party that does not otherwise meet the limitation on benefits rules.

Publicly-traded companies

The Committee may wish to explore the rationale underlying the identification of recognized stock exchanges for purposes of limitations of benefits, and the criteria the Treasury Department considers when negotiating over the definition of a recognized stock exchange. A publicly traded company that is a resident of a treaty country is eligible for all the benefits of the proposed protocol if it satisfies the regular trading test, which requires that the company's principal class of shares (and any disproportionate class of shares) is primarily traded on one or more recognized stock exchanges, and also satisfies either the primary trading test, which requires that the company's principal class of shares be primarily traded on one or more recognized stock exchanges in its country of residence), or the management and control test, which requires that the company's primary place of management and control be in the treaty country of which the company is a resident. In addition, a subsidiary of a company may qualify for benefits as a publicly traded company by satisfying a "vote or value" test under which it establishes that at least 50 percent of vote or value is owned directly or indirectly by five or fewer companies entitled to benefits under the requirements described immediately above (that is, the regular trading test and either the primary trading test or the management and control test). A recognized stock exchange includes certain exchanges specified in the treaty, as well as any other stock exchange agreed upon by the competent authorities of the treaty countries. Trading on exchanges in either treaty country may be considered in determining whether the stock is regularly traded. In determining whether it is primarily traded in its country of residence, the proportion of trades that occur on exchanges within its country of residence must exceed trades in any other single country.

A possible rationale for the U.S. Model treaty's primary trading test is that a publicly-traded company should be eligible for treaty benefits only if it has a nexus with its country of residence, and may underlie the decision in both the proposed protocol and the U.S. Model treaty to permit substitution of the management and control test in lieu of a primary trading test. Accordingly, the Committee may wish to ask the Treasury Department to explain the latitude that is available to the Competent Authorities in identifying other exchanges that may be considered in satisfying the primary trading tests. For example, the Committee may ask about circumstances under which it is appropriate to consider trading that occurs within the economic areas of the treaty countries (for example, in the case of the United States, in a country that is party to NAFTA).

Derivative benefits

The Committee may wish to inquire about the criteria used in determining whether inclusion of a derivative benefits rule is appropriate in a particular treaty. Unlike the U.S. Model treaty, the proposed protocol grants benefits to an entity located in a treaty country if the owners of that entity would have been entitled to treaty benefits had they derived the income directly. To qualify, the company must satisfy both an ownership requirement and a base erosion requirement. The ownership requirement is met if shares representing at least 95 percent of the company's aggregate voting power and value, and at least 50 percent of any of the company's

disproportionate class of shares, are owned directly or indirectly by seven or fewer persons who are equivalent beneficiaries. In the case of indirect ownership, each intermediate owner must be a resident of a member state of the E.U. or a party to the NAFTA agreement. To date, derivative benefits rules have been included in the U.S.-Iceland treaty, entered into force in 2009, in the protocol to the U.S.-Canada treaty entered into force in late 2008, as well as in a number of treaties with countries that are member states of the European Union. In the case of member states of the European Union, special rules addressing withholding rates on intra-community cross-border payments are generally included.

Headquarters companies

The Committee may wish to ask the Treasury Department about the policies that justify deviating from the U.S. Model treaty and including rules in a treaty that grant headquarters companies treaty benefits when those headquarters companies would not be eligible for treaty benefits under any other limitation-on-benefits provision. In the proposed protocol, special rules allow treaty country benefits for a resident of a treaty country that functions as a headquarters company. The benefits are extended if the resident satisfies certain requirements intended to ensure that the headquarters company performs substantial supervisory and administrative functions for a group of companies: (1) that the group of companies is genuinely multinational; (2) that the headquarters company is subject to the same income tax rules in its country of residence as would apply to a company engaged in the active conduct of a trade or business in that country; and (3) that the headquarters company has independent authority in carrying out its supervisory and administrative functions. U.S. income tax treaties in force with Austria, Australia, Belgium, the Netherlands, and Switzerland include similar rules for headquarters companies.

Triangular arrangements

The proposed protocol includes special anti-abuse rules intended to deny treaty benefits in certain circumstances in which a Spanish resident company earns U.S.-source income attributable to a third-country permanent establishment and is subject to little or no tax in the third jurisdiction and Spain. Although the U.S. Model treaty does not include rules addressing triangular arrangements, similar anti-abuse rules are included in other recent treaties and protocols. The Committee may wish to confirm that inclusion of such rules is indicative of a shift in U.S. tax treaty policy rather than a concern specific to the jurisdiction with which the treaty is negotiated. The Committee may also wish to inquire whether the Treasury Department will insist on inclusion of anti-abuse rules whenever a treaty partner's internal tax rules provide an exemption for the income of a third-country permanent establishment of a treaty partner resident.

Scope of discretion for grant of benefits by the competent authority

The Committee may wish to inquire whether it is appropriate to grant discretion to competent authorities to extend treaty benefits to persons not otherwise entitled to such benefits, and, if so, the standard for exercise of any such authority. As in the U.S. Model and other recently negotiated treaties with modern limitations on benefits articles, the proposed protocol includes a grant of discretion to the competent authority to extend otherwise unavailable treaty

benefits to a party that is not otherwise entitled to treaty benefits. The conditions are placed on the exercise of that discretion in the proposed protocol differs from that of the U.S. Model and other recent treaties.

In the U.S. Model treaty, the competent authority is required to determine whether there was a principal purpose of obtaining treaty benefits before exercising his discretion to grant benefits. Although a test that requires examination of motive and principal purpose can be considered a subjective test, the application of such a test to an entity requires the review of the series of objective factors: the establishment, acquisition or maintenance and conduct of operations of the entity. The facts and circumstances surrounding each of these aspects of the entity's presence in a treaty jurisdiction are considered to evidence the underlying purpose of the entity.

In contrast, the proposed protocol purports to provide an objective test, requiring that the competent authority evaluate the extent to which the resident of the other country met any of the criteria under other provisions in the article, without regard to motivation. To the extent that this objective test is applied to permit an inadvertent and minor failure to satisfy one of the limitations, the test cures mere foot faults. On the other hand, if loosely applied, the standard could signal that relief is broadly available notwithstanding failure to comply with the requirements of one of the explicit limitations. In that case, it may inadvertently encourage the treaty shopping that the limitation on benefits rules are intended to discourage.

The OECD Model does not include an article similar to the limitations-on-benefits article in the proposed protocol or U.S. Model, but inclusion of such an article is under consideration in response to one of the action items in the Action Plan on Base Erosion and Profit Shifting, undertaken by the OECD at the request of the G-20.[49] Action Six in that plan is identifying ways to prevent inappropriate extension of treaty benefits. A discussion draft report on the issue includes two draft articles designed to stem treaty abuse. The first is a detailed limitations-on-benefits article similar to the U.S. Model. The second is an article that generally disallows treaty benefits, notwithstanding any other provision in the treaty, if one can reasonably conclude after a review of facts and circumstances that obtaining treaty benefits was one of the main purposes of an arrangement or transaction.[50] The model limitations-on-benefits article includes the discretionary authority to extend benefits based on the principal purpose test as well as the detailed rules.

2. Mandatory Arbitration

Although tax treaties traditionally have not included a mechanism to ensure resolution of disputes, the addition of mandatory procedures for binding arbitration as part of the mutual agreement procedures has become increasingly frequent in recent years. If the proposed protocol enters into force, the U.S.-Spain treaty will be the fifth bilateral U.S. income tax treaty

[49] The full Action Plan, published July 19, 2013 is available at www.oecd.org/ctp/BEPSActionPlan.pdf.

[50] OECD, *Public Discussion Draft BEPS Action Item 6: Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*, available at http://www.oecd.org/tax/beps-reports.htm.

to require binding arbitration of unresolved cases. Mandatory binding arbitration is provided upon request of the taxpayer in paragraph 5 of Article 25 (Mutual Agreement Procedure) of the OECD Model treaty. Proponents of mandatory arbitration believe that incorporating into the mutual agreement process a mechanism that would ensure the resolution of disputes would impel the competent authorities to reach mutual agreement, so as to avoid any arbitration proceedings. As a result, these proponents hold the view that cases will be resolved more promptly and on more appropriate bases through the mutual agreement procedure than previously, although actual arbitration may be rare. In considering the proposed protocol, the Committee may wish to consider the extent to which the inclusion of mandatory arbitration rules and the particular features of the arbitration provisions in the proposed protocol now represent the United States policy regarding mandatory binding arbitration. In particular, the Committee may wish to inquire about the criteria on which the Treasury Department determines whether to include such provisions in a particular treaty, the appropriate scope of issues eligible for determination by binding arbitration, the absence of precedential value of arbitration determinations, the role of the taxpayer in an arbitration proceeding and how to ensure adequate oversight of the use of mandatory arbitration.

Criteria for inclusion of mandatory binding arbitration in a particular treaty

The Committee may wish to ask whether the Treasury Department intends to seek inclusion of mandatory arbitrary provisions in future U.S. income tax treaties and protocols. If not, the Committee may wish to inquire about the basis on which the Treasury Department determines whether a particular treaty should include mandatory and binding arbitration. Given the absence of a mandatory arbitration provision in the recent treaties with Malta and New Zealand, as well as the pending treaties with Hungary, Chile and Poland, and in the inclusion of such a provision in the pending protocol with Switzerland, it appears that inclusion is not yet standard.

Mandatory arbitration provisions are found in the 2009 protocol to the U.S.-France treaty, which entered into force in December 2009, the U.S.-Belgium treaty, which entered into force at the end of 2007, the protocol to the U.S.-Spain treaty, which entered into force at the end of 2007, and the protocol to the U.S.-Canada treaty, which entered into force at the end of 2008. The staff of the Joint Committee on Taxation has provided detailed analyses of those arbitration provisions,[51] including the "last best offer" or "final offer" arbitration methodology adopted in the treaty with Belgium and the protocols with Spain and Canada.[52] Those analyses also include

[51] See Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and France* (JCX-49-09), November 6, 2009; Joint Committee on Taxation, *Explanation of Proposed Income Tax Treaty Between the United States and Belgium* (JCX-45-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Spain* (JCX-47-07), July 13, 2007; Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Canada* (JCX-57-08), July 8, 2008.

[52] In "last best offer" or "final offer" arbitration, each of the parties proposes one and only one figure for settlement, and the arbitrator must select one of those figures as the award. The methodology is intended to encourage the competent authorities not to assert unreasonable claims. In the United States, this arbitration methodology is also informally known as "baseball arbitration" because it is similar to the procedure used to resolve Major League Baseball salary disputes. In the proposed protocol, the competent authorities are permitted to provide

descriptions of mandatory arbitration procedures adopted in the OECD Model treaty and by the European Union.

Regardless of whether the Treasury Department expects mandatory arbitration to become a standard feature in all future U.S. tax treaties, the Committee may wish to inquire whether the Treasury Department intends to develop and publish a standardized set of arbitration principles and procedures for inclusion in a revision to the U.S. Model treaty.

Scope

The scope of cases with respect to which mandatory arbitration is available has varied among the protocols and treaties entered into force to date. The Committee may wish to consider whether the scope of cases eligible for mandatory arbitration in the proposed protocol is appropriate. Under the proposed protocol, the substantive issues for arbitration do not include determination of residence of companies or cases which the competent authorities agree are not suitable. The scope of cases eligible for binding arbitration in the treaties that have entered into force varies greatly, though all grant discretion to the competent authorities to determine that a case is not suitable for arbitration.[53] The Committee may wish to inquire as to the Treasury Department's preferred approach and the circumstances in which the Treasury Department is willing to deviate from that approach. In particular, the Committee may wish to consider whether mandatory arbitration should be available for all articles under a treaty or only for articles that have given rise to cases that historically have been difficult to resolve under the mutual agreement procedure and the factors the competent authorities are expected to take into account in deciding that a particular case is or is not suitable for arbitration. Although granting broad discretion to the competent authorities in making such a decision may facilitate agreements in individual cases, the lack of explicit factors for deciding which cases may go to arbitration may create unpredictability for taxpayers and undermine the efficacy of the mandatory arbitration procedure.

Absence of reasoned opinion and precedential value

Under the proposed protocol, the arbitration panel must limit its determination to stating an amount of income, expense, or tax reportable to the competent authorities. In addition, under the proposed protocol, like the treaties with France, Belgium and Canada, the determination will not state a rationale and is accorded no precedential value. In contrast, the diplomatic notes

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alternative proposed resolutions if the there are issues, the resolution of which, is contingent on the outcome of the other issues.

[53] The protocols to the U.S.-Spanish treaty and U.S.-Canada treaty mandate arbitration if a case involves the application of one or more of the following articles of the treaty (and is not a particular case that the competent authorities agree is not suitable for determination by arbitration): Article 4 (Residence), but only to the extent the case relates to the residence of natural persons; Article 5 (Permanent Establishment); Article 7 (Business Profits); Article 9 (Related Persons), and Article 12 (Royalties), but only to the extent the case relates (1) to the application of Article 12 to transactions involving related persons or (2) to an allocation of amounts between taxable and nontaxable royalties. In contrast, cases under either the U.S.-France treaty or U.S.-Belgium treaty may be resolved through arbitration in any case involving the application of any article of the treaty.

accompanying the U.S.-Spain treaty includes a statement that although decisions of the arbitration panel do not have precedential effect, it is expected that decisions ordinarily will be taken into account in subsequent competent authority cases involving the same taxpayer, the same issue, and substantially similar facts, and may also be taken into account in other cases in which appropriate. The Committee may wish to inquire, whether the omission of such a statement from the proposed protocol should be accorded any significance.

The Committee may also wish to inquire whether the lack of a stated rationale for the determination of an arbitration panel is consistent with appropriate standards of transparency and accountability of tax administration. To the extent that the persons qualified to be appointed to arbitration panels serve on multiple cases or are involved in the handling of cases on behalf of clients who present cases to the competent authorities, there may be a body of private law may develop, providing a competitive edge for certain taxpayers and their representatives familiar with previous cases and posing a barrier for other representatives to develop the necessary expertise. Such competitive disparities could result without any inappropriate behavior by any of the concerned persons, representatives or arbiters.

Taxpayer participation

Under the proposed protocol and other treaties that provide for mandatory arbitration, the presenter is entitled to submit a written statement of his analysis and views of the case to the arbitration panel. The Committee may wish to consider whether U.S. tax treaties should explicitly provide an opportunity for the presenter of the case to provide a submission directly to the competent authorities in all cases under the mutual agreement procedures, and not only in mandatory arbitration proceedings. The U.S. Model treaty does not provide the presenter of a case an explicit opportunity to participate in a case that is being resolved under the standard mutual agreement procedure. Instead, the negotiations are conducted country-to-country by the competent authorities. The taxpayer's participation is generally limited to presenting its case to the competent authority to which the taxpayer initially presented the case, after which the competent authority may or may not relay the substance of the taxpayer's views during negotiations with the other competent authority. The Committee may wish to inquire about the extent to which the opportunity for the presenter of the case to submit written analysis and views directly to an arbitration panel is a substantive difference in the level of participation available to the presenter under the standard mutual agreement procedure.

Required Treasury report on mandatory arbitration

As a condition of ratifying the recently considered protocol with Switzerland, the Committee commented on the proposed mandatory arbitration and recommended extending the existing reporting requirements included in the resolution of advice and consent to ratification of the 2009 protocol to the treaty with France to the Swiss protocol.[54] Specifically, the condition requires a two-part report. First, within two years after the protocol enters into force, and before the first arbitration conducted pursuant to the mandatory arbitration procedure, the Treasury

[54] See, Senate Committee on Foreign Relations Report to accompany Protocol Amending Tax Convention with Switzerland, S. Exec. Report 113-7, April 29, 2014, pp. 5-8.

Department must submit the text of the rules of procedure applicable to arbitration panels, including conflict of interest rules to be applied to members of the arbitration panel, to the Senate Committees on Finance and Foreign Relations and the Joint Committee on Taxation. The second part of the report requires specific data on the arbitrations conducted. This portion of the report must be submitted by the Treasury Department to the Joint Committee on Taxation and the Senate Committee on Finance within 60 days after a determination is reached in the 10th arbitration proceeding conducted pursuant to any of the treaties that require binding arbitration, and be submitted annually for five years following the first year in which it is submitted. The Committee may wish to consider expanding the scope of the required Treasury Report to include information with respect to the arbitration procedure of the proposed protocol.

3. Zero Withholding on Parent-Subsidiary Dividends

In general

When certain conditions are met, the proposed protocol eliminates withholding tax on dividends paid by a company that is resident in one treaty country to a company that is a resident of the other treaty country and that owns at least 80 percent of the stock of the dividend-paying company (often referred to as "direct dividends"). The elimination of withholding tax on direct dividends is intended to reduce the tax barriers to direct investment between the two treaty countries.

Under the present treaty, direct dividends may be taxed by the source country at a maximum rate of 10 percent. Both Spain and the United States impose withholding tax on direct dividends under their internal tax laws. The principal effects of the zero-rate provision on U.S. taxpayers and the U.S. tax base would be to relieve U.S. companies of the burden of Spanish withholding tax on dividends qualifying for the zero rate, to increase the U.S. tax base by eliminating foreign tax credits for Spanish withholding tax that would be imposed in the absence of the zero-rate provision, and to decrease the U.S. tax base by eliminating the U.S. withholding tax on dividends paid by U.S. companies to Spanish companies eligible for the zero rate.

Until 2003, no U.S. income tax treaty provided for a complete exemption from dividend withholding tax, and the U.S. and OECD models do not provide an exemption. By contrast, many bilateral income tax treaties of other countries eliminate withholding taxes on direct dividends between treaty countries, and the EU Parent-Subsidiary Directive repeals withholding taxes on intra-EU direct dividends. Recent U.S. income tax treaties and protocols with Australia, Japan, Mexico, the Netherlands, Sweden, the United Kingdom, Belgium, Denmark, Finland, Germany, France, and New Zealand include zero-rate provisions. The Senate ratified those treaties and protocols in 2003 (Australia, Mexico, United Kingdom), 2004 (Japan, Netherlands), 2006 (Sweden), 2007 (Belgium, Denmark, Finland, and Germany), 2009 (France), and 2010 (New Zealand). The zero-rate provisions in those treaties are similar to the provision in the proposed protocol.[55]

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[55] The treaty with Japan provides a zero-percent rate at a lower ownership threshold than the threshold in the proposed protocol and the other treaties (more than 50 percent as opposed to at least 80 percent).

Description of provision

Under the proposed protocol, the withholding tax rate is reduced to zero on dividends paid by a treaty-country resident company and beneficially owned by a company that is a resident of the other treaty country and that has directly owned shares representing at least 80 percent of the voting power of the company paying the dividend for the 12-month period ending on the date on which entitlement to the dividend is determined.

Eligibility for the benefits of the zero-rate provision is subject to a more stringent set of limitation-on-benefits requirements than normally apply under the proposed protocol. To qualify for the zero rate, the dividend-receiving company must: (1) satisfy the public trading test of the limitation-on-benefits article; (2) meet the ownership and base erosion test and satisfy the active trade or business conditions of the limitation-on-benefits article with respect to the dividend in question; (3) satisfy the derivative benefits test of the limitation-on-benefits article; or (4) receive a favorable determination from the competent authority.

The proposed protocol provides that the zero-rate provision will have effect for amounts paid or credited on or after the date on which the proposed protocol enters into force.[56]

Questions

The proposed protocol with Spain would bring to 13 the number of U.S. income tax treaties that provide a zero rate for direct dividends. Because zero-rate provisions are a relatively recent but now prominent development in U.S. income tax treaty practice, the Committee may wish to consider possible costs and benefits of zero-rate provisions such as revenue considerations and diminishing of barriers to cross-border investment; the Treasury Department's criteria for determining when a zero-rate provision is appropriate; and certain specific features of zero-rate provisions such as ownership thresholds, holding-period requirements, the treatment of indirect ownership, and heightened limitation-on-benefits requirements. These issues have been described in detail in connection with the committee's previous consideration of proposed income tax treaties and protocols that have included zero-rate provisions.[57]

Although zero-rate provisions for direct dividends have become a common feature of U.S. income tax treaties signed in the last decade, the U.S. Model treaty does not provide a zero-rate for direct dividends. In previous testimony before the Committee, the Treasury Department has indicated that zero-rate provisions should be allowed only under treaties that have restrictive limitation-on-benefits rules and that provide comprehensive information exchange. Even in those treaties, according to previous Treasury Department statements, dividend withholding tax should be eliminated only based on an evaluation of the overall balance of benefits under the

[56] This effective date applies to all taxes withheld at the source. This would include, for example, withholding on interest and royalties, as well as dividends.

[57] See, for example, Joint Committee on Taxation, *Explanation of Proposed Protocol to the Income Tax Treaty Between the United States and Germany* (JCX-47-07), July 13, 2007, pp. 82-84.

treaty. Every recent U.S. income tax treaty or protocol has included restrictive limitation-on-benefits provisions and comprehensive information exchange provisions. The committee therefore may wish to inquire into whether there are other particular considerations that the Treasury Department will now take into account in deciding whether to negotiate for zero-rate direct dividend provisions in future income tax treaties and protocols. The committee also may wish to ask whether any new U.S model income tax treaty might provide an elimination of withholding tax on direct dividends and, if it would not so provide, why it would not.

B. Commitment to Negotiate Toward an Agreement Between Puerto Rico and Spain

The committee may wish to consider the appropriate U.S. tax policy toward the Commonwealth of Puerto Rico in the context of the income tax treaty relationship between the United States and Spain. This consideration might include a broader evaluation of U.S. tax treaty policy in relation to the U.S. territories.

The discussion below describes the provisions of the proposed protocol and the 1990 treaty related to Puerto Rico; provides an overview of the legal and, in particular, tax framework governing the relationship between the United States and Puerto Rico and the other U.S. territories; describes briefly the economies of Puerto Rico and the other territories and includes data about cross-border trade between Puerto Rico and Spain; and evaluates U.S. tax treaty policy toward Puerto Rico and the other U.S. territories and possible changes to that policy.

Treaty provisions related to trade between Puerto Rico and Spain

The Memorandum of Understanding signed contemporaneously with the proposed protocol includes a paragraph (paragraph 3) under which the United States and Spain "commit to initiate discussions as soon as possible, but no later than six months after the entry into force of the 2013 Protocol, regarding the conclusion of an appropriate agreement to avoid double taxation on investments between Puerto Rico and Spain."

Paragraph 3 of the Memorandum of Understanding references paragraph 3 of the 1990 protocol. Paragraph 3 of the 1990 protocol provides, "The Parties [the United States and Spain] agreed to initiate, as soon as possible, the negotiation of a Protocol to extend the application of this Convention to Puerto Rico, taking into account the special features of the taxes applied by Puerto Rico."

Following U.S. income tax treaty policy not to apply treaties to the U.S. territories, the 1990 treaty generally does not apply to Puerto Rico or the other U.S. territories, and the proposed protocol does not extend the application of the treaty to Puerto Rico or the other U.S. territories.[58] Consequently, among other things, when a resident of Puerto Rico derives income in Spain or a resident of Spain derives income in Puerto Rico, the treaty's restrictions on source-basis taxation, such as reduced or zero withholding tax rates on dividends, interest, and royalties, are not available. Instead, the domestic tax laws of Puerto Rico and Spain apply to income from cross-border investments between the two jurisdictions.

[58] See Art. 3(1)(b) (defining "United States," when used in a geographic sense, to include the 50 U.S. states and the District of Columbia but not the U.S. territories). Under U.S. internal law (section 7651), however, the IRS is permitted to obtain information from Puerto Rico and the other U.S. territories in response to a proper request for information made under Article 26 of the treaty. For more detail, see the description above of proposed protocol Article XIII.

Background

Puerto Rico is one of 13 territories under the jurisdiction of the U.S. Department of the Interior.[59] Five of these 13 territories (American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands) have significant populations. The Northern Mariana Islands and Puerto Rico are commonwealths. Commonwealth status typically involves a legal relationship with the United States that is embodied in a written mutual agreement. Territories that do not have commonwealth status generally have less developed legal relationships with the United States. The governments of these latter territories are generally constituted by U.S. Federal statutes referred to as organic acts. The five U.S. territories with significant populations are represented in the U.S. Congress by non-voting delegates (in the case of Puerto Rico, a non-voting resident commissioner) in the House of Representatives. Residents of Guam, the Northern Mariana Islands, Puerto Rico, and the U.S. Virgin Islands are generally U.S. citizens. American Samoa residents, by contrast, are generally nationals but not citizens.

The economies of Puerto Rico and the other U.S. territories differ from one another and from the economy of the United States as a whole.[60] Puerto Rico and the other territories are generally poorer than the United States as a whole. Per-capita Gross Domestic Product ("GDP") in each of American Samoa, Guam, the Northern Mariana Islands, and Puerto Rico is below the per-capita GDP in any of the U.S. states. The patterns of business activity in the territories vary both from one territory to another and from the United States as a whole.

Puerto Rico and Spain have significant bilateral trade. In 2013, exports of merchandise from Puerto Rico were $62.4 billion in the aggregate, and imports of merchandise into Puerto Rico were $45.0 billion in the aggregate.[61] Of those totals, exports to Spain accounted for $1.5 billion, and imports from Spain were $339 million.[62]

The application of the Federal tax rules to Puerto Rico and the other U.S. territories varies from one territory to another.[63] Three territories, Guam, the Northern Mariana Islands, and the U.S. Virgin Islands, are referred to as mirror Code possessions because the Internal Revenue Code of 1986, as amended from time to time, serves as the internal tax law of those territories (generally substituting the particular territory for the United States wherever the Code

[59] The source of information about the territories included in this paragraph is the website of the Office of Insular Affairs of the Department of the Interior: http://www.doi.gov/oia/index.html.

[60] For a more detailed description of the economies of the U.S. territories, see Joint Committee on Taxation, *Federal Tax Law and Issues Related to the United States Territories* (JCX-41-12), May 14, 2012, pp. 3-6.

[61] Puerto Rico Trade Balance by Country and by North American Industry Classification System (NAICS), 2011 to 2013, Commonwealth of Puerto Rico, Office of the Governor, Planning Board, Januar 2014, p. xvii.

[62] Ibid, p. xxi. Exports to all European countries totaled $12.1 billion in 2013, and imports from all European countries totaled $11.8 billion.

[63] For a lengthier discussion of U.S. tax law and issues related to the U.S. territories, see the document cited in the immediately preceding footnote.

refers to the United States).[64] A resident of one of those territories generally files a single tax return only with the territory of which the individual is a resident, and not with the United States. American Samoa and Puerto Rico, by contrast, are non-mirror Code possessions. These two territories have their own internal tax laws, and a resident of either American Samoa or Puerto Rico may be required to file income tax returns with both the territory of residence and the United States.

Federal tax rules apply to Puerto Rico and the other U.S. territories in a manner that is different from their application in relation to both the States and foreign countries. Broadly, an individual resident of a territory is exempt from U.S. tax on income that has a source in that territory but is subject to U.S. tax on U.S.-source and non-possession-source income. A corporation that is organized in a territory is generally treated as a foreign corporation for U.S. tax purposes. On the other hand, a number of Code provisions have effect in Puerto Rico or all of the territories as if the territories were U.S. states. For example, the tax credit for research and experimentation has been available for research conducted in a territory. Historically, the Federal tax rules also have included preferences for territory activities. Until its expiration in 2006, the section 936 possession tax credit permitted qualifying U.S. corporations a credit against their U.S. tax liability in respect of possession-source income. After section 936 expired, a similar, temporary provision was enacted for American Samoa activities, and the section 199 domestic production activities deduction was expanded temporarily to include production activities conducted in Puerto Rico. These temporary special rules for American Samoa and Puerto Rico have been extended multiple times since their enactment but expired at the end of last year and have not yet been extended.

There are no bilateral income tax treaties between Puerto Rico (or any other U.S. territory) and any other country.

U.S. tax treaty policy toward Puerto Rico and the other U.S. territories

U.S. bilateral income tax treaties generally define the United States as not including the U.S. territories and generally do not treat territory residents as residents of the United States.[65] As described previously, the 1990 treaty and the proposed protocol follow this approach. Consequently, among other things, the 1990 treaty's restrictions on source-basis taxation do not apply to individuals resident in, or corporations organized in, Puerto Rico or the other U.S. territories.

It is understandable that U.S. income tax treaties do not cover Puerto Rico or the other U.S. territories: Individuals resident in the territories are generally taxed in the United States in a manner more similar to non-U.S. residents than to U.S. residents, and corporations organized in the territories likewise are subject to U.S. tax in a manner more similar to foreign corporations

[64] Following common current and historical usage, this document uses the term "possessions" interchangeably with "territories."

[65] For an example of a typical definition of the United States, see United States Model Income Tax Convention of November 15, 2006, Article 3(1)(i) (excluding U.S. territories from the definition of United States).

than to domestic corporations. Moreover, territory residents may benefit from favorable tax regimes in the territories, such as the U.S. Virgin Islands' economic development incentives and, more recently, Puerto Rico's tax incentives for individuals and businesses.[66] If U.S. income tax treaty benefits were conferred on territory residents, consideration would need to be given to whether those benefits should be restricted in any way as a result of preferential tax regimes in the territories.[67] Restrictions on treaty benefits as a result of territory tax preferences would be consistent with the long-standing U.S. treaty policy against tax sparing.

On the other hand, the exclusion of territory residents from treaty benefits such as reductions in source country taxation may be in tension with the goals of some U.S. internal laws applicable to the territories. For example, the possession tax credit was intended to encourage economic activity in the territories. Economic activity might be discouraged, though, if, because they are not eligible for the benefits of U.S. income tax treaties, territory residents with cross-border income must pay more in source country income taxes on that income than their peers in the United States or in foreign countries with similar treaty reductions in source taxation would face on the same income. Economic development similarly might be hampered if potential foreign investors in mirror Code territories face 30-percent gross-basis withholding tax on dividends and other payments from those territories rather than the lower treaty rates that would apply to U.S.-source payments.

This last concern – that imposition of the mirror Code 30-percent withholding tax might discourage inbound investment – underlies the Guam Foreign Investment Equity Act.[68] Under that law, the rate of gross-basis withholding tax imposed on a Guam-source payment to a nonresident individual or a foreign corporation is generally the same as the rate of tax that would apply if Guam were treated as part of the United States for purposes of U.S. income tax treaty obligations. Because Guam is a mirror Code territory, in the absence of this law, the generally applicable U.S. withholding tax rate of 30 percent would apply to Guam-source cross-border payments. By permitting treaty reductions of withholding tax to apply to these payments, the law extends mirror Code treatment to the treaty context. One question is whether enactment of the same or a similar rule for the other mirror Code territories (the Northern Mariana Islands and U.S. Virgin Islands) merits consideration. By contrast, American Samoa and Puerto Rico have the discretion under present law to reduce or eliminate source-basis taxation of American-Samoa-source and Puerto-Rico-source payments to foreign investors. The Puerto Rico government, for example, could choose unilaterally to reduce Puerto Rican taxation of Puerto-Rico-source income derived by residents of Spain (or by residents of other countries with which

[66] For a description of recently enacted incentives, see Ivan Castano, "Puerto Rico Moves to Encourage Profit Shifting, Boost Collections," *Bloomberg BNA Daily Tax Report,* May 28, 2014, p 1-1.

[67] In the context of the income tax treaty between the United States and Spain, the 1990 protocol's special provision related to Puerto Rico would require the United States and Spain to "tak[e] into account the special features of the taxes applied by Puerto Rico."

[68] Pub. L. No. 107-212 (Aug. 21, 2002). See also H.R. Rep. No. 107-48, Apr. 24, 2001; S. Rep. No. 107-173, June 24, 2002.

the United States has income tax treaties in force). A special rule like the one enacted for Guam therefore may be unnecessary.

Even if Puerto Rico were to reduce or eliminate under its domestic tax law source-basis taxation of Puerto Rico source income derived by residents of Spain, Puerto Rican investors in Spain would be taxed under Spain's generally applicable internal tax laws unless Spain also were to grant unilateral relief to Puerto Rico residents.

More broadly, assuming the existing treaty is not extended in application to Puerto Rico, resolution of bilateral legal questions otherwise addressed by the treaty would instead be governed by the domestic laws of Puerto Rico and Spain.