

DEPARTMENT OF THE TREASURY
TECHNICAL EXPLANATION OF
The Convention Between
The United States of America and The Kingdom of Spain
For the Avoidance of Double Taxation and
The Prevention of Fiscal Evasion
With Respect to Taxes on Income
Signed at Madrid on February 22, 1990

INTRODUCTION

This technical explanation of the Convention between the United States of America and the Kingdom of Spain for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion ("the Convention") is an official guide to the Convention. It reflects the policies behind particular Convention provisions, as well as understandings reached during the negotiation of the Convention with respect to the interpretation and application of the Convention. The Convention consists of 30 articles and a protocol containing 20 provisions.

The first of the principal purposes of the Convention is to avoid the double taxation of income derived by residents of either the United States or Spain from sources within the other country. The Convention describes the persons to which it applies, the income taxes covered by it, and provides that each country will allow a credit against the tax liability of its residents for income taxes paid to the other country. Rules are provided for the taxation at source of various types of income such as business profits, capital gains, shipping and air transport income, dividends, interest, royalties, and employment income, with special provisions for certain categories of persons, such as government employees, diplomats, students, artistes, and athletes. Although Spain imposes a limited capital tax on individuals, taxes on capital are not covered by the Convention as the United States does not impose such taxes and, thus, there is no double taxation to be reduced or eliminated. The Convention also provides procedures under which representatives of the two countries may reach mutual agreement in resolving questions of double taxation or application of the Convention.

The second of the principal purposes of the Convention is to prevent avoidance or evasion of the income taxes of the two countries. To this end, the Convention provides that the United States and Spain will exchange information necessary to administer the Convention and their national laws regarding income taxation. The Convention also contains "anti-treaty shopping" provisions which are intended to prevent residents of third countries from structuring their activities for the purpose of obtaining benefits provided by the Convention.

The Convention contains the traditional "saving clause" under which, with certain exceptions, each country preserves the right to tax its residents and citizens as if the Convention had not come

into effect. The Convention is not intended to reduce the U.S. statutory tax liability of U.S. citizens or residents or Spain's taxation of its residents; instead it provides a mechanism for determining which treaty partner shall reduce or alleviate any double taxation arising when both treaty partners impose taxes on the same income.

The United States and Spain negotiated the treaty on the basis of the U.S. Model Convention for the Avoidance of Double Taxation and Prevention of Fiscal Evasion as revised in June 1981 (U.S. Model), several recently negotiated treaties of the two countries, and the Organization for Economic Cooperation and Development's (OECD) Model Double Taxation Convention on Income and on Capital published in 1977 (OECD Model), from which much of the U.S. Model is derived.

Article 1. GENERAL SCOPE

Article 1 identifies the persons who come within the scope of the Convention. Paragraph 1 provides that, in general, the Convention applies to persons who are residents of one or both of the Contracting States. The term "resident" is defined in Article 4 (Residence). In certain cases, the Convention may also apply to residents of third States because of their relationship to a Contracting State (or resident thereof) or because they are citizens (but not residents) of a Contracting State. As examples, Article 21 (Government Service) grants benefits to third country residents or nationals employed by a Contracting State in the other Contracting State and Article 27 (Exchange of Information and Administrative Assistance) may apply to an exchange of information concerning residents of third States.

Paragraph 2 provides that the Convention shall not restrict any exclusion, exemption, deduction, credit, or other allowance provided by the laws of either Contracting State or by any other agreement between the Contracting States. That is, nothing in the Convention shall deny a taxpayer any benefits granted by U.S. or Spanish law or other agreements between the United States and Spain. Thus, if a deduction would be allowed under the Internal Revenue Code of 1986 ("the Code") in computing the U.S. taxable income of a Spanish resident, such deduction is generally available to such person in computing taxable income under the Convention. Paragraph 2, however, does not authorize a taxpayer to make inconsistent choices between internal law rules and rules of the Convention. Thus, if a taxpayer claims the benefits of a provision of the Convention, he must use the rules of the Convention relevant to such benefit, and must use such rules consistently. For example, if a resident of Spain claims the benefits of the "attributable to" rule of paragraph 1 of Article 7 (Business Profits) with respect to the taxation of a U.S. permanent establishment, he must use the "attributable to" concept consistently for all items of income and deductions and may not rely upon the "effectively connected" rules of the Code. In no event, however, is application of the Convention to increase U.S. tax liability from what that liability would be if there were no Convention.

Paragraph 3 contains the traditional "saving clause" under which each Contracting State reserves the right to tax its residents and its citizens as if the Convention had not come into effect. A Contracting State may apply the saving clause to any person treated as a resident of that State for tax purposes unless such person is determined, in accordance with the tie-breaking provisions of

Article 4, to be a resident of the other Contracting State for purposes of the Convention. The saving clause also may be applied by a Contracting State to tax its citizens. Although bilateral language with respect to citizens was adopted, it is understood that Spain does not impose income taxes on the basis of citizenship.

In order to confirm the applicability of section 877 of the Code under the Convention, the first provision of the Protocol provides that the Convention's definition of citizens includes certain former citizens whose loss of citizenship had as one of its principal purposes the avoidance of tax. In such case, a former U.S. citizen, even if granted Spanish citizenship, may continue to be subject to U.S. income tax in accordance with the provisions of Code section 877, but only for a period of ten years following the loss of his U.S. citizenship. In such case, the competent authorities are to consult as to whether a principle purpose of the loss (renunciation) of citizenship was the avoidance of U.S. tax, but final determination will be made by the United States.

Because of the "saving clause," the Convention generally does not reduce the statutory tax liability of U.S. or Spanish taxpayers to their own country. Instead, the Convention provides for relief from double taxation of income through deductions, credits, reduced withholding rates, and other treaty benefits. It also provides for the determination of a single State of residence. Note, however, that even if an otherwise dual-resident person is determined to be a resident of Spain by application of Article 4, he will remain subject to U.S. taxes if he is a U.S. citizen.

In general, because Article 4 of the Convention provides for the determination of a single state of residence for those persons covered by the Convention, the saving clause has two effects; it preserves the right of the state of residence to tax its residents in those cases where an exclusive right to tax is granted (absent the saving clause) to the other state, for example, because the other state is the state of source for the income; and it preserves the right of a Contracting State to tax its citizens in those cases where the citizen is a resident of the other Contracting State (as determined under Article 4) and an exclusive right to tax is granted (absent the saving clause) to that other Contracting State as the state of residence. However, if the United States taxes its citizens in accordance with the saving clause, a credit, subject to the provisions of Article 24 (Relief from Double Taxation), will be allowed for taxes paid to Spain in accordance with other provisions of the Convention.

Paragraph 4 sets forth certain exceptions to the saving clause. These exceptions ensure that provisions of the Convention explicitly intended to alter a person's tax liability to his country of residence or citizenship fulfill their intended objective. Subparagraph (a) provides that the saving clause does not affect the provisions of paragraph 2 of Article 9 (Associated Enterprises), paragraph 4 of Article 20 (Pensions, Annuities, Alimony, and Child Support), and Articles 24 (Relief from Double Taxation), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure). Thus, notwithstanding the saving clause, these provisions apply to all residents and citizens of the United States or Spain. For example, when the United States taxes a U.S. citizen resident in Spain, it is nevertheless bound to follow the provisions of Articles 24 and 26. This means that the United States must grant a credit under the provisions of Article 24 for taxes paid to Spain by that person and that person may avail himself of competent authority proceedings in either Spain, on account of residence, or in the United States, on account of citizenship.

Paragraph 4(b) provides a second category of exceptions to the saving clause. Under this subparagraph, benefits of the enumerated articles are provided by a Contracting State to certain residents who are not citizens of that State and do not have immigrant status in that State. This second category of exceptions includes benefits conferred under Articles 21 (Government Service), 22 (Students and Trainees), and 28 (Diplomatic Agents and Consular Officers). In the case of the United States, the term "immigrant status" is understood to refer to a person admitted to the United States as a permanent resident under U.S. immigration laws (i.e., having been issued a "green card") regardless of whether the person is physically present in the United States. Thus, the saving clause as modified by paragraph 4(b) only preserves the right of the United States to tax citizens and aliens (non-citizens) having permanent residence under U.S. immigration laws (alien residents holding green cards). This means that, in the cases covered by paragraph 4(b), the United States agrees to give up the right to tax those alien residents not holding green cards when an exclusive right to tax such persons or their income has been granted to Spain by the Convention (for example, Spanish students determined under Code section 7701(b)(3) to have a substantial presence in the United States).

Article 2. TAXES COVERED

Paragraph 1 of Article 2 identifies the existing taxes to which the Convention applies. The Spanish taxes covered are the income tax on individuals and the corporation tax (which includes the tax imposed by Spain with respect to insurance or reinsurance premiums obtained in Spain by foreign companies). In the United States, the covered taxes are the Federal income taxes imposed by the Code, but excluding social security taxes. U.S. taxes such as the estate, gift, and generation skipping transfer taxes and unemployment insurance taxes are not covered by the Convention as they are not taxes on income. However, paragraph 1 covers the excise taxes imposed with respect to insurance premiums paid to foreign insurers (Code section 4371) except to the extent that the risks are reinsured with a person not exempt from such tax under this or another U.S. Convention. It also covers the excise taxes imposed with respect to private foundations (Code sections 4940-4948).

Provision 2 of the Protocol limits the application of the Convention with respect to the personal holding company tax (Code section 541) and the accumulated earnings tax (Code section 531). Provision 2(a) exempts a Spanish company from liability for the personal holding company tax only for taxable years in which all of that Spanish company's stock is owned in their capacity as individuals by individuals who are not residents or citizens of the United States. Thus, if there are any corporate owners or U.S. citizen or resident owners, that Spanish company may be liable for the personal holding company tax. As provided for in provision 2(b), Spanish companies which are described in paragraph 1(f) of Article 17 (Limitation on Benefits), which pertains to publicly traded companies, are exempt from the accumulated earnings tax. In general, this is intended to provide such a Spanish company a guarantee that it will not have to prove that its earnings and profits have not accumulated beyond the reasonable needs of the company. It is understood that such publicly traded companies are unlikely to be mere holding or investment companies and that the interests of the shareholders of such companies are likely to operate so as to prevent an unreasonable accumulation of earnings and profits.

Paragraph 2 provides that the Convention shall also apply to any taxes imposed subsequent to the date of signature of the Convention (February 23, 1990) which are identical or substantially similar to the taxes existing on that date and covered by the Convention. It is agreed that the competent authorities shall notify each other of any significant changes in their respective tax laws and of any official published material relating to the application of the Convention, such as this Technical Explanation.

Article 3. GENERAL DEFINITIONS

Paragraph 1 of Article 3 defines the principal terms used in the Convention. Unless the context otherwise requires, a term defined in this paragraph has a uniform meaning throughout the Convention. A number of important terms are defined in other articles. For example, the terms "resident of a Contracting State" and "permanent establishment" are defined in Articles 4 (Residence) and 5 (Permanent Establishment), respectively, and the terms "dividends," "interest," and "royalties" are defined in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties), respectively.

The term "Spain" is defined to mean the Spanish State and, when used in a geographical sense, includes the Spanish territorial waters, and any area beyond the territorial waters which, in accordance with international law and the laws of Spain, is an area within which the rights of Spain with respect to the natural resources of the seabed, subsoil, and superjacent waters may be exercised.

The term "United States" is defined to mean the United States of America and, when used in a geographical sense, includes the States and the District of Columbia, the U.S. territorial waters, and any area beyond the territorial waters which, in accordance with international law and the laws of the United States, is an area within which the rights of the United States with respect to the natural resources of the seabed, subsoil, and superjacent waters may be exercised. Puerto Rico and all other U.S. possessions and territories are not included within this definition of the United States. However, in provision 3 of the Protocol, Spain and the United States agree to initiate negotiations to extend application of the Convention to Puerto Rico. Puerto Rico is currently studying this proposed treaty extension.

The terms "Contracting State" and "the other Contracting State" are defined to mean Spain or the United States depending on the context in which the term is used. That is, a provision using the terms "Contracting State" and "other Contracting State" is bilateral and "Contracting State" may be interpreted, as necessary, to be either Spain or the United States.

The term "person" is defined to include an individual, a company, and any other body of persons. The term "company" means any body corporate or any entity which is treated as a body corporate for tax purposes. Provision 4 of the protocol clarifies that the term "any other body of persons" specifically includes estates, trusts, and partnerships. It is understood that, under Spanish law, the income of partnerships, estates, and trusts is only taxed in the hands of the partners or beneficiaries. Furthermore, it is understood that the term "any other body of persons" includes any

other persons, as defined under domestic law, which may be subject to tax, such as foundations, cooperatives, associations, and other similar groups of individuals and companies.

The terms "enterprise of a Contracting State" and "enterprise of the other Contracting State" mean an enterprise carried on by a resident (as defined in Article 4) of the United States or Spain, as the context requires. However, no definition of the term "enterprise" is included in the Convention. Any question as to whether an activity is performed within the framework of an enterprise or is deemed in and of itself to constitute an enterprise is to be resolved by reference to the appropriate domestic law. Although the definition of "enterprise of a Contracting State" refers to an activity carried on by a resident of a Contracting State and the concept of resident is not limited to legal persons, it is understood that most activities carried on by natural persons (individuals) will be covered by Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services) and will not be considered enterprises. However, where an individual personally conducts an enterprise, that is, a trade or business involving the risk of capital with the intent to generate profits, for example, as a sole proprietor, that enterprise and such profits are covered by Article 7 (Business Profits).

A "national" is defined as any individual possessing nationality of the relevant Contracting State, as well as any legal person, association, or other entity deriving its status as such from the laws of the relevant Contracting State (or any of its political subdivisions or local authorities). It is understood that a U.S. citizen possesses the nationality of the United States. The term "national" is used in Articles 4 (Residence), 21 (Government Service), 25 (Non-Discrimination), and 26 (Mutual Agreement Procedure).

The term "international traffic" means any transport by a ship or aircraft except where such transport is solely between places in the other Contracting State. The term "solely between places in" is understood not to be synonymous with "wholly within," thus, transport entering international airspace or waters may be considered domestic traffic provided the pickup and delivery points are both within the same Contracting State. The transport of goods from Barcelona to the United States, leaving some of the goods in Norfolk and the remainder in Baltimore, would be considered entirely international traffic, as the goods are being transported between Barcelona and Norfolk or Barcelona and Baltimore, but no goods are being transported solely between Norfolk and Baltimore. Note: the cabotage laws of the United States, in general, prevent transportation of goods by enterprises of a foreign country between U.S. ports of origin and destination and, specifically, would prohibit a Spanish enterprise from picking up goods in Norfolk for delivery to Baltimore in the above example. Thus, in general under U.S. law, an enterprise of Spain legally transporting goods to or from any U.S. destination must be engaged in international traffic. The definition of international traffic is relevant for purposes of Articles 8 (Shipping and Air Transport) and 13 (Capital Gains).

The term "competent authority" is defined to mean, in the case of the United States, the Secretary of the Treasury or his delegate. Questions concerning delegation of this authority should be addressed to the Assistant Commissioner (International) of the Internal Revenue Service. In the case of Spain, the term means the Minister of Economy and Finance or his authorized representative.

Paragraph 2 provides that, in the case of a term not defined in the Convention, the domestic law of the Contracting State applying to the undefined term shall control, unless the context in which the term is used requires a definition independent of domestic law or the competent authorities reach agreement on a meaning pursuant to Article 26 (Mutual Agreement Procedure). The phrase "unless the context otherwise requires" refers to the purpose and background of the provision in which the term appears.

Pursuant to the provisions of Article 26, the competent authorities of the Contracting States may resolve by mutual agreement any difficulties or doubts arising as to the interpretation or application of the Convention, for example, the meaning of a term. An agreement by the competent authorities with respect to the meaning of a term used in the Convention would supersede conflicting meanings in the domestic laws of the Contracting States.

Article 4. RESIDENCE

Article 4 sets forth rules for determining the residence of individuals, companies, and other persons for purposes of the Convention. Article 4 is important because, except as otherwise provided, only a resident of a Contracting State may claim benefits under the Convention. A determination of residence under this Article applies for all other provisions of the Convention. In general, the determination of residence begins with a person's liability for tax as a resident under the respective taxation laws of the Contracting States. It is understood that the fact that the income of a person, such as a partnership, charitable organization, or pension fund, is exempt from tax in a Contracting State is not to be construed to deny such person's status as a resident of that State under the Convention. A person who is subject to tax as a resident under the laws of one, and only one, Contracting State need look no further to determine his residence with respect to the Convention; he is a resident of the Contracting State in which he is subject to tax. However, Article 4 is also designed to assign residence to a single State for purposes of the Convention in those cases where a person is a resident for tax purposes of both Contracting States under their respective laws. The definition of residence in Article 4, of course, is exclusively for purposes of the Convention.

In general, the term "resident of a Contracting State" incorporates the definitions of residence in U.S. and Spanish law by referring to a resident as any person who, under the laws of a Contracting State, is liable for tax in that Contracting State because of his residence, domicile, place of management, place of incorporation, or other similar criteria. As applied to the United States, the term "resident" would include resident alien individuals (as determined under Code section 7701(b)), and aliens present in the United States making an election under Code section 6013(g) or (h). Unlike the U.S. Model, a citizen of a Contracting State is not automatically a resident of that Contracting State for the purposes of the Convention. This is a departure from the U.S. Model, under which all U.S. citizens are treated as U.S. residents. Furthermore, certain residents for tax purposes may be excluded from consideration as residents under Article 4. Provision 5(a) of the Protocol provides that for a U.S. citizen or an alien admitted to the United States for permanent residence under U.S. immigration laws (i.e., having been issued, and holding, a

"green card") to be a resident of the United States for purposes of Spanish tax, that citizen or green card holder must either have a substantial presence in the United States or be treated as a U.S. resident, and not a third country resident, under the principles of paragraphs 2(a) and 2(b) of Article 4. A "green card holder" resident in a third country is outside the scope of the Convention.

In accordance with the provisions of the second sentence of paragraph 1, a person lacking domicile, residence, place of management, place of incorporation, or other criteria of similar nature in a Contracting State is considered not to be a resident of that Contracting State even though he is considered to be a resident according to the domestic laws of that State and is subject to tax in that State with respect to income from sources within that State. That is, territorial basis taxation of a person, such as a diplomat, by a Contracting State does not necessarily make that person a resident of that Contracting State for purposes of the Convention.

Provision 5(b) of the Protocol provides that a partnership, estate, or trust is a resident of a Contracting State only to the extent that the income derived by such person is subject to tax by such Contracting State as the income of a resident. Thus, under the Convention, a partnership, estate, or trust will be treated as a resident of the United States only to the extent that the income derived by such partnership or estate is subject to tax by the United States as the income of a U.S. resident (such as a U.S. resident partner of the partnership). Similarly, if a resident of Spain and a resident of a third State form a partnership, and the partnership derives dividends from the United States, the limitation on U.S. withholding taxes under the provisions of Article 10 (Dividends) applies only to the share of dividends attributable to the partner resident in Spain.

Provision 5(c) of the Protocol confirms that a Contracting State, in and of itself, and any political subdivisions thereof, shall be treated as residents of that Contracting State for purposes of the Convention. This is of particular importance in clarifying that benefits of the Convention available to a resident of a Contracting State are also available to the government of that Contracting State; for example, it ensures that the Article 10 (Dividends) limitation on withholding applies to dividends derived by a Contracting State from shares in a company which is a resident of the other Contracting State.

Paragraph 2 provides a series of tie-breaking rules for assigning residence to an individual who under paragraph 1 is a resident of both Contracting States. The first test depends upon where the individual has a permanent home available. If this test is inconclusive because the individual has a permanent home in both States, he is considered a resident of the State with which his personal and economic relations are closer, that is, the State which is the center of his vital interests. If such a center of vital interest cannot be determined, or if he does not have a permanent home available to him in either State, residence is where the individual has an habitual abode. If he has an habitual abode in both States or in neither of them, he is deemed to be a resident of the State of which he is a national (as defined in Article 3 (General Definitions)). Should the individual be a national of both States or of neither of them and otherwise fail the tests for determining a single state of residency, the competent authorities of the Contracting States shall settle the question of residence by mutual agreement under the authority of Article 26 (Mutual Agreement Procedure).

Under provision 5(a) of the Protocol, the first two of these tie-breaking rules may be used to determine whether a U.S. citizen or green card holder in the United States is a resident, for the purposes of the Convention, of the United States or some third country. That is, a U.S. citizen living and working in France is not entitled to benefits of this Convention as a resident of the United States unless he has a substantial presence in the United States or the application of paragraphs 2(a) and 2(b) results in a determination that the U.S. citizen is a resident of the United States and not of France.

Paragraph 3 provides that when a person other than an individual (e.g., a corporation) is a resident of both Contracting States under paragraph 1 (e.g., it is liable to tax in Spain by reason of place of management and in the United States by reason of incorporation), then the competent authorities shall endeavor to settle the question of residency by mutual agreement. Should the competent authorities be unable to agree upon a single state of residency, that entity shall be treated as a resident of neither Contracting State with respect to income received by it. However, it will be treated as a resident of both Contracting States for the purpose of certain payments made by it. This is relevant when benefits of the Convention depend upon the source of income being from a resident of a Contracting State. For example, Article 10 (Dividends) provides reduced withholding rates with respect to dividends beneficially owned by a resident of a Contracting State when the source of the dividends is a company resident in the other Contracting State – in this case, a company resident in both Contracting States.

The denial of residency to an otherwise dual resident company is not viewed as unduly harsh to the taxpayer, as in most cases the circumstances giving rise to the dual residency of a legal person are under the control of that person. For instance, the dual resident entity which has chosen to have its place of effective management in Barcelona may resolve the dual residency issue by not incorporating in the United States.

Article 5. PERMANENT ESTABLISHMENT

Article 5 defines the term "permanent establishment" which, in particular, is relevant to the taxation of business profits under Article 7 (Business Profits). Paragraph 1 defines the term "permanent establishment" as a fixed place of business through which the business of an enterprise is wholly or partly carried on.

Paragraph 2 provides an illustrative, but not exhaustive, list of fixed places of business or activities which constitute a permanent establishment. The list includes: a place of management; a branch; an office; a factory; a workshop; and a mine, an oil or gas well, a quarry, or any other place of extraction of natural resources. The term "place of management" was included in paragraph 2 to provide closer conformity to the OECD Model. Because a place of management will in most, but not all, cases include another activity listed in paragraph 2, such as an office, it is understood that the addition of "place of management" generally does not expand the definition of permanent establishment so as to include a fixed place of business that would otherwise not be included.

Paragraph 3 provides a qualification to the definition of permanent establishment with respect to building sites; construction or installation projects; and installations, drilling rigs, or ships used for the exploration or exploitation of natural resources and provides that such projects, installations, rigs, or ships give rise to a permanent establishment only if they last for a period of more than six months. For the purpose of computing the six month time period, the consecutive activities of associated enterprises (as defined in Article 9 (Associated Enterprises)) will be treated as the activities of a single enterprise. Thus, if a construction company subcontracts with an associated enterprise for the completion of a project and removes itself from the Contracting State prior to the expiration of the six month period, the associated enterprises shall be deemed, nonetheless, to have a permanent establishment in the Contracting State if the subcontractor continues the project beyond the six month threshold.

Paragraph 4 overrides paragraphs 1, 2, and 3 to provide that a fixed place of business may be used for one or more preparatory or auxiliary activities and not rise to the level of a permanent establishment. The list of preparatory and auxiliary activities includes: 1) the use of facilities for the sole purpose of storage, display, or delivery of the enterprise's inventory; 2) the maintenance of an inventory for the sole purpose of storage, display, or delivery; 3) the maintenance of an inventory for the sole purpose of processing by another enterprise; 4) the maintenance of a fixed place of business for the sole purpose of acquiring inventory or of collecting information for the enterprise; and 5) the maintenance of a fixed place of business for the sole purpose of carrying on any other activity of a preparatory or auxiliary character for the enterprise. Such other preparatory or auxiliary activities are understood to include advertising, the supply of information, and scientific research. However, this is not intended to suggest that such activities are always auxiliary or that other activities – such as servicing patents or reviewing architectural plans – cannot be auxiliary activities. Paragraph 4 concludes with a provision that any combination of the specified preparatory or auxiliary activities does not constitute a permanent establishment so long as the overall combined activity remains a preparatory or auxiliary activity.

Paragraphs 5 and 6 describe the permanent establishment implications of employees and agents. Under paragraph 5, the activities of a person (other than an agent of an independent status to whom paragraph 6 applies) acting in a Contracting State on behalf of an enterprise of the other Contracting State shall be deemed to be a permanent establishment of that enterprise in the first-mentioned State if that person has and habitually exercises in that State an authority to conclude contracts on behalf of the enterprise, unless his activities are solely of an auxiliary or preparatory character as characterized in paragraph 4. Thus, if a U.S. company that does not have a fixed place of business in Spain hires an agent who has the power to conclude contracts on behalf of the company and who during a taxable year materially participates in Spain in the conclusion of contracts for the sale of goods on behalf of the company to residents of Spain, then the activities of such person would constitute a permanent establishment of the U.S. company to the same extent that those activities would constitute a permanent establishment if undertaken directly by the enterprise.

Paragraph 6 provides that if an enterprise of one Contracting State merely carries on business in the other Contracting State through a broker, general commission agent, or any other agent of independent status acting in the ordinary course of his business, the enterprise will not thereby be

considered to have a permanent establishment in that other State. This provision may hold even if the activities of the agent are substantially or totally devoted to the enterprise, so long as the transactions between the agent and the enterprise are conducted during the ordinary course of the agent's business and the agent is truly independent of the enterprise.

Paragraph 7 provides that the determination of whether a company, which is a resident of a Contracting State, has a permanent establishment in the other Contracting State is to be made without regard to the fact that the company is related to a second company which either is a resident of the other Contracting State or carries on business in the other Contracting State. Any relationship to other companies is not sufficient in and of itself to make a permanent establishment determination. For the purpose of the Convention, the parent-subsidiary relationship is not relevant. That is, the existence of a subsidiary in a Contracting State shall not necessarily determine that the parent, an enterprise of the other Contracting State, has a permanent establishment in the first mentioned Contracting State. So long as the subsidiary is independent of the parent, its activities in a Contracting State will not bring the parent into the taxing jurisdiction of that State.

Article 6. INCOME FROM REAL PROPERTY (IMMOVABLE PROPERTY)

Paragraph 1 of Article 6 provides that income from real property, including income from agriculture and forestry, may be taxed by the Contracting State in which the property is situated. The term "real property" is intended to be synonymous with the term "immovable property" and is defined in paragraph 2. The right to tax in the state of situs of the property (source state), is not exclusive; the rule simply confers upon the source state the primary right to tax such income regardless of whether the income is derived through a permanent establishment in that State. Therefore, it not necessary for the United States to invoke the saving clause of paragraph 3 of Article 1 (General Scope) to tax income from Spanish real property owned by a U.S. resident or citizen. The Convention does not limit the amount of tax imposed by a Contracting State on real property income. Income derived from real property includes income from rights such as an overriding royalty or a net profits interest in a natural resource.

Paragraph 2 defines real property as having the meaning it has under the laws of the Contracting State in which the property is situated. Following the OECD Model Double Taxation Convention, two explanatory sentences are provided in paragraph 2. The second explanatory sentence specifically provides that ships, aircraft, and containers used in international traffic are not real property. However, the second sentence is not intended to imply that containers not used in international traffic are real property – such a determination is to be made by reference to the domestic law of the State in which the container is used. Paragraph 3 provides that the rule in paragraph 1 applies irrespective of the form of exploitation of the real property, that is, it does not matter whether the income is derived from the direct use, leasing, or any other use of the real property.

Paragraph 4 makes it clear that income from real property (paragraph 1) and income from the rental of real property (paragraph 3) are taxable in the state of situs of the property, irrespec-

tive of the existence of a permanent establishment or fixed base to which the property could be attributed. This does not prevent income from real property derived through a permanent establishment from being treated as business income of an enterprise; it merely insures that income from real property will be taxable in the state of situs, even when such property is not part of a permanent establishment. That is, the provisions of the Article are not intended to prejudge the application of domestic law in the taxation of income from real property. They merely preserve the right of the state of situs to tax such income.

Paragraph 5 provides a special rule intended to permit Spain to tax imputed rental income in certain cases where real property held by a company or other entity is made available to the owner of shares or other rights in such company or entity. The paragraph provides that, where ownership or participation rights in a company include a right to enjoy property situated in a Contracting State, the income, either actual or imputed, from that property right may be taxed in that Contracting State. Thus, for example, when a U.S. corporation owns a Spanish resort property and grants time-share rights to that property to its shareholders, Spain, subject to the other provisions of the Convention, may tax the imputed rental value of that property (either to the company or to its shareholders) in accordance with domestic law.

Paragraph 5 of the U.S. Model, which provides that there be available a binding election to be taxed on a net basis with respect to real property income, was omitted from the Convention. Such an election is generally available under United States law with respect to U.S. real property. In the case of Spanish real property, income from real property is taxed on a net basis if such property is attributable to a permanent establishment or fixed base and such income is part of the business income of such permanent establishment or fixed base. On the other hand, if a person deriving income from Spanish real property fails to create a permanent establishment in Spain, the passive investment income arising from that property will generally be subject to a gross basis withholding tax in Spain, which is currently imposed at a 25 percent rate.

Article 7. BUSINESS PROFITS

Article 7 provides rules for the taxation by a Contracting State of income from business activities carried on in that State by a resident of the other Contracting State. The Convention does not contain an explicit definition of "business profits." Hence, such profits are defined under the relevant Contracting State's domestic law. Unlike the U.S. Model, income from the rental of tangible personal property and films is defined as royalty income, and is taxed as such, under the provisions of Article 12 (Royalties).

With respect to the business profits of an enterprise of a Contracting State, paragraph 1 provides an exclusive taxing right to that Contracting State (state of residence of the person carrying on that enterprise) unless the enterprise carries on or has carried on business in the other Contracting State through a permanent establishment situated therein, in which case the other Contracting State may tax that portion of the enterprise's business profits which is attributable to that permanent establishment. The term "permanent establishment" is defined in Article 5 (Permanent

Establishment). The phrase "shall be taxable only in that State" used in paragraph 1 (and elsewhere in the Convention) to grant an exclusive taxing right to the state of residence means "shall not be taxable in the other Contracting State". That is, the business profits of a Spanish enterprise with operations in France, but not in the United States, shall not be taxable in the United States. Whether such profits "shall be taxable only in [Spain]." or also in France, depends upon Spain's relationship with France, which is beyond the scope of the Convention.

Paragraph 2 provides that the profits to be attributed to the permanent establishment are those which it might be expected to make if it were a distinct and independent enterprise engaged in the same or similar activities under the same or similar conditions. Thus, arm's-length pricing standards may be used in determining the income of the permanent establishment arising from transactions with other parts of the enterprise and from transactions with related parties. The phrase "attributed to that permanent establishment" means that, subject to the rules described above, the Code section 864(c)(3) "effectively connected with a U.S. trade or business" rule does not apply. Business profits from sources outside of a Contracting State, however, may be attributable to a permanent establishment within the Contracting State. Thus, items of income described in Code sections 864(c)(4)(B) and (C) which are attributable to a permanent establishment in the United States are subject to tax by the United States.

Paragraph 3 provides that, for the purpose of determining the business profits of a permanent establishment, there shall be allowed as deductions the expenses incurred for the purposes of the permanent establishment, whether incurred in the State where the permanent establishment is located or elsewhere. Deductible expenses include a reasonable amount of executive and general administrative expenses. Deductions are also allowed for interest, research and development expenses, and other similar expenses which are incurred for the purposes of the permanent establishment. It is understood that such expenses include expenses incurred by the enterprise as a whole, or by any part thereof which includes the permanent establishment, so long as they are incurred for a specific purpose of the permanent establishment. For example, a reimbursement to the head office for interest expenses incurred by the head office on behalf of the permanent establishment and charged to the permanent establishment is a deductible expense.

Paragraph 4 provides that no business profits will be attributed to a permanent establishment merely because it purchases goods or merchandise for the enterprise of which it is a permanent establishment. This rule refers to a permanent establishment which performs more than one function for the enterprise, including purchasing. For example, the permanent establishment may purchase raw materials for the enterprise's manufacturing operation and sell the manufactured output. While business profits may be attributable to the permanent establishment with respect to its sales activities, no profits are attributable with respect to its purchasing activities. On the other hand, it is understood that the expenses of such purchasing activities are not deductible expenses of the permanent establishment. If the sole activity were the purchasing of goods or merchandise for the enterprise the issue of the attribution would not arise, because, under paragraph 4(d) of Article 5 (Permanent Establishment), there would be no permanent establishment.

Paragraph 5 clarifies that the United States is not using its statutory trade or business concept (Code section 864(c)(3)) in determining the business profit of a permanent establishment. That is, when a permanent establishment avails itself of the treaty benefits using the "attributable to" concept, it may rely upon that concept so long as it is used consistently from year to year. The permanent establishment may not arbitrarily change between the "attributable to" concept of the Convention and the Code's concept of "effectively connected" to minimize tax liabilities. Moreover, in determining business profits, a permanent establishment using the "attributable to" concept in determining gross income must use the "attributable to" concept in determining the costs or losses associated with that income; net income may not be determined using inconsistent concepts.

Paragraph 6 provides that where business profits include items of income dealt with separately in other Articles of the Convention, the provisions of those separate Articles take precedence over the provisions of Article 7. Thus, for example, the taxation of income from international shipping and transport dealt with in Article 8 (Shipping and Air Transport) is governed by that Article and not by Article 7. Similarly, the taxation of dividends, interest, and royalties is controlled by Articles 10 (Dividends), 11 (Interest), and 12 (Royalties); however, those Articles provide that where dividends, interest, or royalties derived by a resident of a Contracting State are attributable to a permanent establishment or fixed base of that resident in the other Contracting State, the provisions of this Article or Article 15 (Independent Personal Services) shall apply with respect to that income.

Article 7 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that, in general, the United States may tax the business profits of enterprises carried on by its citizens and residents without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax granted to the state of residence in paragraph 1, the United States may tax the business profits of an enterprise carried on by an individual who is a resident of Spain (and which are not attributable to a U.S. permanent establishment) if that individual is a U.S. citizen. In doing so, a credit, subject to the provisions of Article 24 (Relief from Double Taxation), shall be allowed for Spanish taxes imposed upon the enterprise pursuant to the provisions of paragraph 1.

Article 8. SHIPPING AND AIR TRANSPORT

Paragraph 1 of Article 8 grants an exclusive taxing right, with respect to profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic, to the Contracting State of which the person carrying on the enterprise is a resident (state of residence). International traffic is defined in paragraph 1(h) of Article 3 (General Definitions). As stated in the discussion of paragraph 6 of Article 7 (Business Profits), this Article takes precedence over the rules of Article 7. Thus, the other Contracting State may not tax such profits even if they are attributable to a permanent establishment of the enterprise in that other State. Gains from the alienation of ships and aircraft operating in international traffic, and from containers pertaining to the operation thereof, are dealt with in paragraph 5 of Article 13 (Capital Gains), which grants a similar exclusive taxing right to the Contracting State of which the enterprise is a resident.

Provision 6 of the Protocol clarifies what income is to be considered profits from the operation of ships or aircraft and states that "income from the operation of ships or aircraft in international traffic" is to be interpreted in accordance with paragraphs 5 to 12 of the Commentary to Article 8 of the OECD Model. As such, it is understood that full charters of ships and aircraft used in international traffic are covered by paragraph 1. However, international shipping profits include rents from bareboat charters made by shipping and aircraft companies only when such charters are occasional and incidental to the international traffic operations of those companies. Rental income from bareboat charters which are not occasional and incidental to the lessor's international traffic operations are not covered by this Article, but may be covered by other articles of the Convention. Thus, if an oil company which owns a deep-water tug (used in its offshore oil explorations) were to make a bareboat rental of that tug during periods of idle use, the income from such rental would not be covered by Article 8 because such company is not normally engaged in international traffic. It is also understood that the occasional and incidental leasing of terminal facilities for the loading and unloading of cargo or passengers would be an auxiliary activity covered by the definition of international shipping profits.

Moreover, it is clear from the OECD Commentary that the "profits of an enterprise of a Contracting State from the operation of ships or aircraft in international traffic" include those profits accruing to the enterprise which are attributable to transport between places in the other Contracting State when such transport is in connection with or incidental to transport outside of the other Contracting State, regardless of whether such transport is actually conducted by the enterprise. That is, because such transport is not solely between places within the other Contracting State but, rather, is in connection with or incidental to transport outside of the other Contracting State, such transport is covered by the definition of international traffic. For example, when a shipping enterprise of a Contracting State engaged in transport of goods to the other Contracting State undertakes to provide, in connection with such transport, for the transshipment and delivery by rail of the transported goods to a consignee within the other Contracting State and derives profits from either direct payments by the consignee or commissions from the transshipment agent, such profits are part of the shipping enterprise's profits from the international traffic and, as such, are not taxable in the other Contracting State.

Profits of an enterprise of a Contracting State from the use, maintenance, or rental of containers, and related equipment for the transport of containers, used for the transport of goods or merchandise in international traffic are treated as royalties. However, provision 9 of the Protocol provides that such royalties are taxable only by the Contracting State of which the recipient is a resident. It is understood that in the context of provision 9, the term "containers" includes related equipment incidental to the transport of containers, such as cranes and trailers.

Paragraph 2 provides that the provisions of paragraph 1 apply to profits from the participation of an enterprise of a Contracting State in a pool, a joint business, or an international operating agency which is engaged in international traffic. It is understood, however, that only so much of the joint profits as are attributable to the enterprise's share in the joint operation are covered by Article 8.

Article 8 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that, in general, the United States may tax its citizens and residents on income from the operation of ships and aircraft in international traffic without regard to the Convention. Specifically, this means that, irrespective of the exclusive taxing right granted to the state of residence in paragraph 1, the United States may tax shipping income derived by a resident of Spain if that resident is a U.S. citizen. In that case, a credit, subject to the provisions of Article 24 (Relief from Double Taxation), will be granted for Spanish taxes on that shipping income imposed pursuant to Article 8.

Article 9. ASSOCIATED ENTERPRISES

Article 9 confirms the right of the Contracting States to allocate items of income, deductions, credits, or allowances in transactions between related parties. As such, it confirms and complements Code section 482. Under paragraph 1, any conditions made or imposed between related enterprises in their commercial or financial relations which differ from those that would be made between independent enterprises may be ignored by the Contracting States. A Contracting State may include in the income of an enterprise, and tax accordingly, any profits that, but for those other than arm's-length conditions, would have accrued to one of the enterprises, but by reason of those conditions have not so accrued. Enterprises are related for purposes of the Convention where an enterprise of a Contracting State participates directly or indirectly in the management, control, or capital of an enterprise of the other Contracting State, or the same persons participate directly or indirectly in the management, control, or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

Paragraph 2 describes the consequences of an adjustment made by a Contracting State in accordance with paragraph 1. When an adjustment has been made by a Contracting State, the other Contracting State is to make the appropriate modifications (a "correlative adjustment") to the amount of tax which it charges to the related enterprise. In determining the appropriateness and amount of such adjustment, the other provisions of the Convention are to be taken into account. Thus, if as a result of the adjustment, one enterprise is treated as having made a distribution of profits to the other, the provisions of Article 10 (Dividends) may apply to the deemed distribution. If necessary, the competent authorities are authorized to consult to resolve any differences in the application of these provisions, such as a disagreement over the appropriateness of an adjustment, the characterization of the additional income and deductions, or the application of interest.

Paragraph 1 of Article 9 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope). That is, the United States may tax all U.S. citizens and residents (as determined under Article 4 (Residence)) and Spain may tax all Spanish citizens and residents without regard to the provisions of paragraph 1. Thus, it is understood that paragraph 1 does not limit the right of the United States to apply Code section 482. Paragraph 3 of the U.S. Model is a restatement, rather than a grant of new authority; thus, the omission of paragraph 3 of the U.S. Model in the Convention does not limit the application of U.S. law.

By reason of paragraph 4(a) of Article 1 (General Scope), paragraph 2 of Article 9 is not subject to the provisions of the saving clause of paragraph 3 of Article 1. Thus, because of this exception, the saving clause may not be used by a Contracting State to refuse a request, made pursuant to paragraph 2, that a correlative adjustment be made to the income of an enterprise of that State.

Article 10. DIVIDENDS

Article 10 confirms that, in general, dividends may be taxed by the State of which the recipient is a resident. The Article also provides that when the payer company is a resident of a Contracting State, the dividends may also be taxed by that State. However, if the beneficial owner of such dividends is a resident of the other Contracting State, any tax so charged in the first-mentioned State (state of payer) may not be in excess of the rates specified in paragraph 2: 10 percent of the dividend, where the beneficial owner is a company which owns at least 25 percent of the voting stock of the company paying the dividend, and 15 percent of the dividend in all other cases. The term "beneficial owner" is not defined in the Convention and, thus, is defined by domestic law of the Contracting States. Use of "beneficial owner" rather than "recipient" serves as an anti-treaty shopping measure: the nominal recipient of a dividend payment is ignored in favor of the person actually entitled to the beneficial enjoyment of the dividend.

Paragraph 3 defines "dividends," for the purposes of Article 10, as income from shares or other rights (not being debt-claims) participating in profits and income from other corporate rights taxed in the same way as income from shares under the laws of the State of which the payer company is a resident. Income from certain arrangements, including debt-claims or debt obligations, which carry the right to participate in profits, may be treated as dividends to the extent so treated under the laws of the State in which the income arises. Income from debt-claims not carrying the right to participate in profits is covered by Article 11 (Interest). Thus, it is understood that each Contracting State will apply its domestic law in differentiating dividends from interest and other distributions or disbursements.

Paragraph 4 provides that where dividends, otherwise limited to tax at source at 10 or 15 percent as provided in paragraphs 1 and 2, are attributable to a permanent establishment or fixed base of the recipient in the Contracting State of which the company paying the dividends is a resident, then the dividends are taxable by that State in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), rather than under the provisions of paragraphs 1 and 2. For example, where dividends arising in a Contracting State are paid in respect of holdings forming part of the assets of a permanent establishment maintained in that State by a resident of the other Contracting State, those dividends shall be treated as part of the gross income of the permanent establishment and may be subjected to tax on a net basis as business profits under the provisions of Article 7, possibly at rates in excess of the limitations of paragraph 2.

Paragraph 5 provides that a Contracting State may only impose tax on dividends paid by a company which is a resident of the other Contracting State where (1) dividends are paid to a resident of the first-mentioned State (as provided for in paragraph 1), or (2) the dividends are attributable to a

permanent establishment or fixed base in the first State (as provided for in paragraph 4). For example, if a company which is a resident of Spain pays dividends, those dividends may be taxed by the United States: (1) if paid to a resident of the United States; or (2) if the dividends are attributable to a permanent establishment or a fixed base in the United States. Thus, neither Contracting State may impose a "second" dividend tax of the type imposed by the United States under Code section 861(a)(2) on certain dividends paid by a resident of the other Contracting State.

Provision 7 of the Protocol modifies the application of Article 10 in several ways. First, the definition of dividends is expanded to include profits derived upon a liquidation of a company. Thus, when all of the assets of a corporation are sold and the corporation dissolved, the resulting income flow to the (former) shareholders is treated as a dividend and is subject to the provisions of Article 10. Second, the 10 percent withholding tax limitation of paragraph 2(a) does not apply to income attributable to shareholders of the Spanish corporations and entities referred to in Article 12.2 of Law 44/1978 of 8 September 1978 and Article 19 of Law 61/1978 of 27 December 1978 and successor statutes, provided such income is not taxed at the corporate level by Spain. It is understood that the referenced entities are similar to Real Estate Investment Trusts (REITs) (Code section 856) and Regulated Investment Companies (RICs) (Code section 851) in the United States in that only one level of tax is collected, at the shareholder level. Thus, the shareholders of such Spanish entities may be subject to withholding at rates up to the 15 percent limit of paragraph 2(b). Third, dividends paid by Spanish investment institutions, which are subject to tax in Spain according to Articles 34 or 35 of Law 46 of 26 December 1984 and successor statutes, are also subject to the 15 percent withholding tax limitation of paragraph 2(b), regardless of the percentage of voting stock held by the beneficial owner.

Finally, provision 7 provides special rules for dividends paid by United States REITs and RICs. Dividends from RICs are not subject to the 10 percent limitation of paragraph 2(a) but are subject to the 15 percent withholding limitation of paragraph 2(b). It is understood that it would be inappropriate to provide special relief for dividends when those dividends are owned by a pass-through entity. Dividends from REITs are subject to the 15 percent withholding limitation, but only if the beneficial owner is an individual holding less than a 25 percent interest in the REIT; in other cases, there is no limitation on the withholding rate applicable to dividends from a REIT. That is, conversion of real property income into a dividend by passing it through a REIT controlled by the real property owner should not reduce the tax from the sum that would be due if the income were derived directly. Thus, the appropriate rate on REIT dividends is that rate which approximates the rate which would apply to net income from real property paid directly to the property owner. As income from real property is subject to either a 30 percent withholding rate or a net basis tax of 34 percent in the case of a corporation or 15 or 28 percent in the case of an individual, REIT dividends paid to a corporation or individual owning more than a 25 percent interest in the REIT are taxed at 30 percent. Some relief from this withholding rate is provided in the case of individuals holding a less than 25 percent interest in the REIT. Such individuals are assumed to have been taxable at the 15 percent rate on net real property income and accordingly are taxed at 15 percent on the REIT dividends.

Article 10 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that, in general, the United States may tax its citizens and residents on dividend income without regard to the Convention. Specifically, this means that the United States tax is not subject to the withholding limits imposed by paragraph 2 with respect to dividend income accruing to a beneficial owner who is a resident of Spain if that beneficial owner is a U.S. citizen. For example, if a U.S. citizen fails to furnish his taxpayer identification number to the payer company, the payer may be required to impose the Code section 3406 twenty percent backup withholding. As in other cases where the saving clause is invoked, the United States will grant a credit, under the provisions of Article 24 (Relief from Double Taxation), for any Spanish taxes imposed on the dividends. In any case, the final U.S. tax liability of a U.S. citizen or resident is determined by the filing of a return and application of the Code tax rates to such person's worldwide income. Paragraph 3 of Article 24 provides special relief in cases where U.S. taxation on the basis of citizenship will cause double taxation of U.S. source income.

Article 11. INTEREST

Article 11 confirms that interest may be taxed by the State in which the recipient is resident. The Article also provides that interest arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such interest is a resident of the other Contracting State, then any tax so charged may not be in excess of 10 percent of the gross amount of the interest. The term "beneficial owner" is not defined in the Convention and, thus, is defined by domestic law of the Contracting States. Use of "beneficial owner" rather than "recipient" serves to ensure that substance will prevail over form in determining the appropriate tax treatment; the nominal recipient of an interest payment is ignored in favor of the person actually entitled to the beneficial enjoyment of the interest.

Paragraph 3 provides several limits on source-based taxation of interest. First, when the recipient of the interest arising in a Contracting State is the government of the other Contracting State, its political subdivisions, or local authorities, the interest is exempt from taxation in the source State. Additionally, the competent authorities may agree to exempt interest derived by specified government instrumentalities of the other Contracting State. The competent authorities are to determine the scope of this additional exemption, which may cover, for example, interest on loans made by such governmental corporations as the Export-Import Bank and the Overseas Private Investment Corporation.

A second exemption is provided by paragraph 3 for interest on long-term loans, defined as loans for a period of 5 or more years, granted by banks or other financial institutions. Such interest is exempt from tax in the source state and is taxable only in the Contracting State of which the grantor bank or financial institution is a resident. A final exemption from taxation in the source state is provided for interest paid in connection with the sale on credit of industrial, commercial, or scientific equipment; interest on such commercial credit is taxable only in the state of which the grantor of the credit is a resident. As used in this paragraph, equipment is understood to mean personal property assets used in a trade or business which are depreciable under domestic law, that

is. plant and equipment. It does not include inventory, intangible assets such as patents, or real property assets (land).

Provision 8 of the Protocol provides special treatment for income derived from financial assets covered by Spanish Law 14 of 25 May 1985 and successor statutes. Such income is covered by the definition of interest income; however, when it is subject to a special withholding tax at the time of issue of the financial asset, the paragraph 2 limitation on withholding taxes does not apply. It is understood that Law 14 allows Spain to impose a 55 percent withholding tax on the equivalent of original issue discount at the time of issue of certain bearer bonds, in lieu of taxing bond payments as they mature.

Paragraph 4 contains a definition of interest which is essentially the same as that found in the U.S. Model with two modifications. The first modification is an exclusionary reference to debt-claims carrying a participation in profits which are characterized by the source state as dividends in accordance with paragraph 3 of Article 10 (Dividends). The second modification is a reference to domestic law which expands the usual definition of interest to include any income which is treated as income from money lent by the domestic taxation law in the State in which the income arises. As used in the definition of interest, the phrase "premiums or prizes attaching to such securities, bonds, or debentures" is understood to cover the coupon or redemption payments attached to a "lottery bond". In general, for lottery bonds, a portion of the outstanding bonds are chosen by lot each year for redemption. Because of the element of gambling inherent in these bonds, their use generally is illegal in the United States.

Paragraph 5 provides that where the interest, otherwise limited to tax at source at 10 percent as provided in paragraph 2 or at zero as provided in paragraph 3, is attributable to a permanent establishment or fixed base of the beneficial owner in the Contracting State in which the interest arises, the interest income is taxable by that State in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), rather than under the provisions of paragraphs 2 or 3. For example, where the interest arising in a Contracting State is paid in respect of a debt-claim forming part of the assets of a permanent establishment maintained in that State by a resident of the other Contracting State, that interest shall be treated as part of the gross income of the permanent establishment and may be subject to tax on a net basis as business profits under the provisions of Article 7, possibly at rates in excess of the limitations of paragraphs 2 and 3.

Paragraph 6 provides rules for determining the source of interest payments. Interest paid by the government of a Contracting State, or political subdivisions or local authorities thereof, is sourced in that State. In general, interest paid by a resident of a Contracting State is sourced in that State. However, if the payer has in a Contracting State, whether or not the payer is a resident thereof, a permanent establishment or fixed base and the interest is borne by such permanent establishment or fixed base, then the interest is sourced in that State. The term "borne by" is understood to mean allowable as a deduction in computing taxable income. The source rules of paragraph 6 only apply for the purposes of Article 11: that is, they apply only to the determination

of whether interest may be taxed in the state of source under paragraph 2. The source rules are not relevant for the determination of whether such interest is foreign source income (see Article 24 (Relief from Double Taxation)).

Under paragraph 7, the provisions of Article 11 do not apply to any excessive interest payments accruing to the beneficial owner by reason of a special relationship between the payer and the beneficial recipient, or between both of them and a third person. Any interest exceeding the amount that would have been agreed upon between payer and beneficial owner under arm's-length conditions remains taxable in accordance with the laws of each of the Contracting States, including other provisions of this Convention. For example, the excess amount may be recharacterized as a dividend and taxed accordingly, in which case the provisions of Article 10 (Dividends) apply. It is understood that paragraph 7 does not limit the United States' authority to make an arm's-length adjustment to a related party transaction, even if paragraph 7 does not explicitly allow for the adjustment. Thus, Article 11 does not limit the right of the United States to apply Code section 482.

Article 11 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that, in general, the United States may tax its citizens and residents on interest income without regard to the Convention. Specifically, this means that the United States tax is not subject to the withholding limits imposed by paragraph 2 with respect to interest income accruing to a beneficial owner who is a resident of Spain if that beneficial owner is a U.S. citizen; for example, the twenty percent backup withholding requirement under Code section 3604 may be applied. As always, when invoking the saving clause, the provisions of Article 24 (Relief from Double Taxation) must be respected. In any case, the final U.S. tax liability of a U.S. citizen or resident is determined by the filing of a return and the application of the Code rates to such person's worldwide income.

Article 12. ROYALTIES

Article 12 confirms that royalties may be taxed by the State in which the recipient is resident. The Article provides that royalties arising in a Contracting State may also be taxed by that State in accordance with its laws. However, if the beneficial owner of such royalties is a resident of the other Contracting State, then any tax so charged may not be in excess of the rates specified in paragraph 2: 5 percent of the royalties, if the royalties are described by subparagraph (a), 8 percent if the royalties are described by subparagraph (b), and 10 percent if the royalties are described by subparagraph (c). The term "beneficial owner" is not defined in the Convention and, thus, is defined by domestic law of the Contracting States. Use of "beneficial owner" rather than "recipient" serves to ensure that substance will prevail over form in determining the appropriate tax treatment; the nominal recipient of a royalties payment is ignored in favor of the person actually entitled to the beneficial enjoyment of the royalties.

Paragraph 2 set forth a three-tier treatment of the withholding rate limitation on royalties. Paragraph 2(a) deals with payments received as consideration for the use of "cultural" copyrights, that is, copyrights of literary, dramatic, musical, or artistic work. Such copyrights are subject to the lowest withholding rate limitation – 5 percent.

Paragraph 2(b) applies to three categories of royalties: those paid for the use of image or sound reproductions, those arising from personal property leasing, and those arising from copyrights of scientific works. The broad coverage of image or sound reproductions is intentional and is designed to cover all forms of transmissions or reproductions involving image and/or sound. For example, it includes both cinematographic films used in commercial movie theaters or television broadcasting and home-use video cassette recordings. The personal property leasing category includes industrial, commercial, or scientific equipment of all kinds. For example, it includes payments received for bareboat leases of ships and aircraft which are not covered by the incidental leasing provision of Article 8 (Shipping and Air Transport) and payments for the leasing of drilling rigs. However, such payments are taxed as royalties only when not attributable to a permanent establishment. By virtue of the source rule in paragraph 5, Spain generally taxes such royalties only when paid by a resident of Spain. Moreover, provision 9(a) of the Protocol limits the right to tax royalties or rents received in consideration for containers used in international traffic to the state of which the recipient of the royalties is a resident. It is understood that in this context, the term "containers" includes related equipment incidental to the transport of containers, such as cranes and trailers. The third category of royalties subject to the intermediate rate of paragraph 2(b) includes royalties from the copyright of scientific works. Provision 9(b) of the Protocol provides that whether a payment is in consideration for a copyright of scientific work is to be determined by the domestic law of the Contracting State in which the royalty arises. Such payments could, for example, be determined to be in consideration for the copyright of a literary work or for the use of scientific experience. Royalties received for sound or image transmissions or reproductions, personal property leasing, and copyrights of scientific works may be subject to withholding at a rate not to exceed 8 percent.

Paragraph 2(c) applies a 10 percent withholding rate limitation to all other royalties, that is, those not expressly subject to the 5 or 8 percent rate limitations.

The term "royalties" is defined in paragraph 3. The first part of the definition is similar to that of the U.S. Model, but expands the U.S. Model definition to include payments received as consideration for the use of motion pictures, films, tapes, or other means of image or sound reproduction. The second part of the definition of royalties includes payments received as consideration for the use, or the right to use, industrial, commercial, or scientific equipment, that is, rental payments on tangible property. Such rental payments do not include the income of container leasing companies; as mentioned above, such payments are granted special treatment by provision 9(a) of the Protocol. Payments for technical assistance performed in a Contracting State and related to the application of a right or property giving rise to royalties are given the same treatment as those royalties. As provided for in the last sentence of paragraph 2, royalties for technical assistance are subject to withholding at the same rate applicable to royalties in respect of the underlying property for which the assistance is provided. That is, no attempt is made to distinguish between payments made for, or the withholding rate thereon, a patented process and those made for a technician, supplied by the patent holder, to monitor that process. It is understood that royalties for technical assistance are to be calculated net of labor and cost of materials. The definition of royalties also includes gains derived from the alienation of rights and property which are contingent upon the productivity, use, or disposition thereof as royalties. Note, however, that

income from genuine alienation of rights or property which are not contingent upon the disposition thereof are gains treated by Article 13 (Capital Gains). It is understood that the term "royalties" does not encompass management fees or payments under a bona fide cost-sharing arrangement which are covered by the provisions of Article 7 (Business Profits) or 15 (Independent Personal Income).

Paragraph 4 provides that where the royalties, otherwise limited to tax at source at maximum rates of 5, 8, or 10 percent as provided in paragraph 2, are attributable to a permanent establishment or fixed base of the recipient in the Contracting State, then the royalties are taxable by that State in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), rather than under the provisions of paragraph 2. For example, where the royalties arising in a Contracting State are paid in respect of rights or property forming part of the assets of a permanent establishment maintained in that State by a resident of the other Contracting State, those royalties shall be treated as part of the gross income of the permanent establishment and may be subjected to tax on a net basis as business profits under the provisions of Article 7, possibly at rates in excess of the limitations of paragraph 2.

Paragraph 5 provides rules for determining the source of royalty payments. Royalties paid by the government of a Contracting State, or local authority thereof, are sourced in that State. If the royalties are attributable to a permanent establishment or fixed base located in a Contracting State, the royalties are sourced in that Contracting State, provided that the royalties are borne by such permanent establishment or fixed base. The term "borne by" is understood to mean allowable as a deduction in computing taxable income. However, if the royalties are not borne by a permanent establishment or fixed base located in a Contracting State, then the royalties are sourced in the Contracting State of which the payer is a resident (as determined under Article 4 (Residence)). Finally, when the royalties are not borne by a permanent establishment or fixed base located in a Contracting State and the payer is not a resident of either Contracting State, then the source of the royalties is the state in which the property or rights are used. These rules are a compromise between the U.S. statutory rule which sources royalties in the state in which the property or rights are used and the Spanish rule which sources royalties according to the residence of the payer.

Under paragraph 6, the provisions of Article 12 do not apply to any excessive royalties inuring to the beneficial owner by reason of a special relationship between the payer and the beneficial owner, or between both of them and a third person. Any royalties exceeding the amount that would have been agreed upon between payer and beneficial owner under arm's-length conditions remain taxable in accordance with the laws of each of the Contracting States, including other provisions of this Convention. It is understood that paragraph 6 does not limit the United States' authority to make an arm's-length adjustment to a related party transaction, even if paragraph 6 does not explicitly allow for the adjustment. Thus, Article 12 does not limit the right of the United States to apply Code section 482, even when such application extends beyond the provisions of the Article.

Article 12 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that the United States may tax its citizens and residents on royalties without regard to the Convention. Specifically, this means that the United States tax is not subject to the withholding limits imposed by paragraph 2 with respect to royalties accruing to a beneficial owner who

is a resident of Spain if that beneficial owner is a U.S. citizen. As always, when invoking the saving clause, the provisions of Article 24 (Relief from Double Taxation) must be respected.

Article 13. CAPITAL GAINS

Article 13 provides rules for the taxation at source of certain gains derived from the alienation or sale of real (immovable) property, tangible personal (movable) property, ships or aircraft operated in international traffic, and shares of stock. All other gains are taxable only in the state of residence of the beneficial owner. However, the alienation of intangible property is covered by Article 12 (Royalties) if the gains from the alienation are contingent upon the productivity, use, or disposition of such property.

Paragraph 1 provides that gains derived from the alienation of real property situated in a Contracting State may be taxed in that State. The term "real property" is intended to be synonymous with the term "immovable property" and is defined in paragraph 2 of Article 6 (Income from Real Property). In addition, the phrase "real property situated in the other Contracting State" is defined in provision 10(a) of the Protocol to include, in the case of the United States, a United States real property interest. Thus, the United States retains its full taxing right to impose the tax provided in Code section 897 (relating to gains derived by non-resident aliens or foreign corporations from the disposition of investments in U.S. real property interests). By virtue of Article 25 (Non-Discrimination) and Code section 897(i), a Spanish resident holding a U.S. real property interest is entitled to make the election to be treated as a U.S. corporation with respect to taxation of that real property interest.

In order to grant taxing rights to Spain equivalent to those provided by paragraph 1 and provision 10(a) of the Protocol relating to United States real property interests, paragraph 2 provides that gains from the alienation of ownership rights in a company whose assets consist mainly of Spanish real property may be taxed in Spain. It is understood that Spain interprets "mainly" to mean that the real property assets of the company are greater than its movable (personal) property assets. However, Spain does not currently have internal legislation equivalent to Code section 897 and, in general, does not tax gains from the alienation of shares in a foreign company, even if the assets of that company are mainly Spanish real property. Thus, additional Spanish legislation may be necessary to fully implement the taxing rights accorded by paragraph 2.

Paragraph 3 provides that a Contracting State may tax gains from the alienation of tangible personal property (movable property) which are attributable to a permanent establishment or to a fixed base in that State which belongs to a resident of the other Contracting State. Such gains include those derived from the alienation of the entire permanent establishment or fixed base (either by itself or as part of a larger enterprise). For example, when the assets of a Delaware corporation, including its branch (permanent establishment) in Spain, are sold in their entirety and the corporation liquidated, the gains attributable to the alienation of that branch may be taxed in Spain.

Provision 10(b) of the Protocol provides that removal of personal property from a Contracting State by an enterprise of the other Contracting State may be treated as an alienation of that property and taxed by the first-mentioned State to the extent of the imputed gains accrued as of the date of removal. In this case, subsequent taxation by the state of residence of the enterprise is limited to the gains accruing after the time of removal from the first-mentioned Contracting State. This provision accommodates the Spanish practice of taxing the accrued, but unrealized, gains in such cases and meshes it with the U.S. practice, under Code section 864(c)(7), of taxing gains realized on property previously removed from a U.S. trade or business. Under this compromise formulation, each Contracting State will limit its tax on the resident of the other Contracting State to the gain accrued while the property was in its territory.

Paragraph 4 provides that, if a resident of a Contracting State has a 25 percent or greater participation in the capital of a company which is a resident of the other Contracting State at any time during the 12-month period preceding the alienation of any portion of the stock, participations, or other rights representing such participation in capital, the gains derived from such alienation may be taxed by the other Contracting State. To the extent that domestic source rules in the first-mentioned Contracting State give rise to double taxation, paragraph 4 provides that such gains will be sourced in the State of which the company is a resident. Thus, to the extent that gains from the alienation of shares in a Spanish corporation derived by a U.S. person are taxed by Spain under the provisions of paragraph 4, such gains will be sourced in Spain for purposes of allowing a foreign tax credit. The reference that the resourcing is for purposes of avoiding double taxation is intended to bring this provision within the exception to the saving clause for Article 24 (Relief from Double Taxation), provided in paragraph 4(a) of Article 1 (General Scope).

Paragraph 4 is a significant departure from the U.S. Model, as well as the OECD Model. The United States agrees to permit such a tax based on the rationale that the sale of a substantial holding of the shares of a corporation can be economically comparable to selling a proportionate share of the underlying assets of the corporation, which could be subject to tax as gains under other paragraphs of Article 13 if sold directly. However, there should not be tax in certain cases where there is no actual disposition of those assets, but simply a restructuring of stock ownership among the corporate components of an affiliated group which are residents of the same country. Accordingly, provision 10(c) of the Protocol prevents application of paragraph 4, under certain circumstances, to certain transfers of stock, participations, or other rights between members of a group of companies that file a consolidated tax return.

As applied to transfers of stock, participations, or other rights in a Spanish corporation (Spanish shares) between U.S. corporations, provision 10(c) of the Protocol applies to transfers between members of a group of U.S. companies that file a consolidated U.S. tax return where 1) the transferor and transferee are U.S. companies; 2a) the transferor or the transferee owns, directly or indirectly, 80 percent or more of the voting rights and value of the other, or 2b) a U.S. company owns directly or indirectly (through other U.S. companies) 80 percent or more of the voting rights and value of each of them; and 3) for the purpose of determining gain on any subsequent disposition, the initial cost of the Spanish shares for the transferee is determined based on the cost it had for the transferor, increased by any cash or other property paid. If these conditions are satisfied,

provision 10(c) provides that, to the extent that the consideration received by the transferor consists of stock or other rights in the capital of the transferee (or the capital of another U.S. company that owns directly or indirectly 80 percent or more of the voting rights and value of the transferee) (affiliated group stock), the transfer of the Spanish shares is not an alienation for purposes of paragraph 4 subject to tax in Spain. However, if cash or property other than affiliated group stock ("boot") is received, the amount of the "boot" may be taxed by Spain.

Paragraph 5 grants an exclusive right to tax gains derived from the alienation of ships, aircraft, or containers operated in international traffic by an enterprise of a Contracting State to the Contracting State of which the enterprise is a resident (state of residence). It is understood that the treatment of gains arising from the alienation of personal property pertaining to an enterprise's international traffic operation, including such property as mobile stairways and loading equipment, will be determined in accordance with paragraph 5.

Paragraph 6 provides that the taxation of gains from the alienation of property which are contingent upon the productivity, use, or disposition of such property and which are treated as royalties under the provisions of Article 12 (Royalties) shall not be affected by the provisions of Article 13. Thus, if the alienation of intangible property, described in paragraph 3 of Article 12, is contingent upon the productivity, use, or disposition of such property, the resulting income is to be treated as a royalty covered by Article 12. Thus, where a U.S. resident receives a variable or contingent fee for the sale of a patent to be used in Spain which is set by reference to the use of the patented process, the income from such sale is taxable in Spain as a royalty. On the other hand, if the payment is a fixed fee, then that payment is taxable as a gain in accordance with the provisions of Article 13.

Paragraph 7 grants an exclusive right to tax gains from the alienation of any property not referred to in the preceding paragraphs of the Article to the Contracting State of which the alienator is a resident (state of residence). For example, paragraph 7 covers the sale of a company's stock when the seller has, at all times during the twelve month period preceding such sale, had a less than 25 percent interest in the company.

Article 13 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that the United States may tax its citizens and residents on gains without regard to the Convention. Specifically, this means that, irrespective of the exclusive taxing rights granted to the state of residence in paragraphs 5 and 7, the United States may tax gains from the alienation of ships, aircraft, containers, and property not otherwise specified in the Article sold by a resident of Spain if that resident is a U.S. citizen; in such a case, the United States must respect the provisions of Article 24 (Relief from Double Taxation).

Article 14. BRANCH TAX

Article 14 explicitly confirms the right of a Contracting State to impose a branch tax, that is, a tax which is imposed by a Contracting State on the earnings of an enterprise of the other Con-

Contracting State which are earned through a permanent establishment in the first Contracting State. Such a branch tax imposed on payments or deemed payments from branch to home office can be viewed as analogous to the withholding taxes which would be imposed on the dividends and interest payments made by a subsidiary to a parent corporation.

In the case of the United States, paragraph 1(a) defines the amount of branch profits subject to tax as the "dividend equivalent amount", (see Code section 884(b)), and requires that the profits 1) be effectively connected (or treated as effectively connected) with the conduct of a trade or business in the United States, and 2) be attributable to a permanent establishment situated in the United States or be subject to tax under Article 6 (Income from Real Property) or paragraph 1 of Article 13 (Capital Gains) as income derived from real property situated in the United States. In the latter case, provision 11 of the Protocol makes it clear that, in the case of income subject to tax under Article 6 or paragraph 1 of Article 13 as income derived from U.S. real property, the branch tax may be imposed on such income only when such income is, or has been, subject to tax under Article 6 or paragraph 1 of Article 13 on a net basis. That is, the branch tax may not be imposed on U.S. real property income which has been subject to tax in the United States on a gross basis.

To more fully preserve the right of the United States to impose its branch tax, paragraph 1(b) extends the coverage of the Article to include excess interest payments, as defined by Code section 884(f), deemed to be received by a Spanish corporation which are deducted as interest for purposes of determining income attributable to its U.S. permanent establishment or to the disposition of a U.S. real property interest to the extent such deductible amounts exceed the interest paid. In general, such excess interest payments may be subject to a withholding tax of not more than 10 percent. However, in recognition of the exemption from withholding taxes on interest paid on long-term bank loans (paragraph 2(b) of Article 11 (Interest)) and on interest paid on commercial credit (paragraph 2(c) of Article 11), the withholding tax rate limitation with respect to excess interest payments of the United States permanent establishment of a Spanish bank is 5 percent. Provision 11 of the Protocol defines a "bank," for the purposes of Article 14, as including Spanish savings banks (Cajas de Ahorro).

Paragraph 2 of the Article provides complementary treatment for Spain with respect to the branch taxes described in paragraph 1. Although Spain has statutory provisions for imposition of a branch tax, it is understood that such provisions are not currently implemented. In general, paragraph 2 permits the imposition of a 10 percent withholding tax on the Spanish equivalent of the United States dividend equivalent amount and excess interest expense. However, in the case of the Spanish equivalent of the excess interest expense of a Spanish permanent establishment of a United States bank, the withholding tax rate is limited to 5 percent. In the case of income subject to tax under Article 6 (Income from Real Property) or paragraph 1 of Article 13 (Capital Gains), provision 11 of the Protocol provides that Spain may impose a branch tax only when such income is, or has been, subject to tax under Article 6 or paragraph 1 of Article 13 on a net basis.

Article 15. INDEPENDENT PERSONAL SERVICES

Article 15 addresses the taxation of income from the performance of independent personal services. Independent personal services are professional services or similar activities performed by

an individual, sole proprietorship, or professional partnership for its own account where it receives the income and bears the losses arising from the services. Generally, professional services rendered by a person such as a physician, lawyer, engineer, architect, dentist, or accountant as an individual, sole proprietor, or partner are independent personal services; the same services performed as an employee or as an officer of a company for wages or salary constitute dependent personal services and are addressed in Article 16 (Dependent Personal Services).

When a resident of a Contracting State performs professional services in an independent capacity, paragraph 1 grants an exclusive taxing right with respect to income derived from such services to that State (state of residence). However, this exclusive right is overridden and such income may also be taxed in the other Contracting State if such services are performed in that other State and the income is attributable to a fixed base in that other State which the resident has or had regularly available for the purpose for performing such activities. In such case, the other Contracting State may tax only so much of the income as is attributable to that fixed base.

Article 15 follows the OECD Model in covering independent personal services performed by a resident of a Contracting State, in contrast to the U.S. Model which is limited to individuals. However, Article 7 (Business Profits) takes precedence over Article 15 when such services are attributable to a permanent establishment maintained in the State in which the services are performed. Provision 12 of the Protocol provides that whether a resident has or had a regularly available fixed base in the other Contracting State shall be determined in accordance with the Commentary to Article 14 of the OECD Model and any subsequent guidelines developed by the OECD with respect to that Article. The Commentary makes it clear that such services are to be taxed on a net, rather than gross, basis under principles analogous to those applicable to business profits under Article 7.

An illustrative, but not exhaustive, list of professional services is provided in paragraph 2. It includes the professional services of physicians, lawyers, engineers, architects, dentists, and accountants, as well as independent professional activities of a scientific, literary, artistic, or educational nature.

Article 15 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that the United States may tax its citizens and residents on independent personal service income without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax granted to the state of residence in paragraph 1, the United States, subject to the provisions of Article 24 (Relief from Double Taxation), may tax independent personal service income earned by a resident of Spain if that resident is a U.S. citizen.

Article 16. DEPENDENT PERSONAL SERVICES

Article 16 addresses the taxation of income from the performance of dependent personal services. Dependent personal services are, in general terms, services performed by an individual for wages, salary, or other similar remuneration. With certain exceptions addressed in paragraph 2, paragraph 1

provides that remuneration derived by a resident of a Contracting State from employment in the other Contracting State may be subject to tax in both Contracting States. However, if the conditions of paragraph 2 are satisfied or if the employment is not exercised in the other Contracting State, paragraph 1 provides an exclusive taxing right to the first-mentioned State (state of residence). In addition, the provisions of paragraph 1 may be overridden by other provisions of the Convention in Articles 20 (Pensions, Annuities, Alimony, and Child Support) and 21 (Government Service).

Paragraph 2 restricts the ability of a Contracting State to tax remuneration for employment provided therein by a resident of the other Contracting State in certain circumstances. Notwithstanding the provisions of paragraph 1, such remuneration may be taxed only in the state of residence if three conditions are met with respect to the employee: (1) he is present in the state of employment for an aggregate 183 days or less in any twelve month period; (2) he is paid by, or on behalf of, an employer who is not a resident of the state of employment; and (3) the remuneration is not borne by a permanent establishment or fixed base of the employer in the state of employment. That is, the remuneration is not deductible in computing taxable income of such a permanent establishment or fixed base. If all three conditions are satisfied then the remuneration is taxable only in the state of residence and may not be taxed in the state of employment.

Paragraph 3 provides a special rule, which takes precedence over the other provisions of the Article, for remuneration derived by members of the regular complement of ships or aircraft operated in international traffic by an enterprise of a Contracting State. Such remuneration may be taxed by that Contracting State even if the employee is a resident of the other Contracting State. The term "regular complement" is intended to exclude persons, not part of the permanent crew of a ship or aircraft, who earn income unrelated to the transport operation of that ship or aircraft. For example, local entertainers hired to perform on a cruise ship docked in port are not members of the regular complement of that ship.

Article 16 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that the United States may tax its citizens and residents on employment income without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax granted to the state of residence by the Article in certain cases, the United States, subject to the provisions of Article 24 (Relief from Double Taxation), may tax employment income earned in Spain, or from services as a crew member of a Spanish ship or aircraft, by a Spanish resident if that resident is a U.S. citizen.

Article 17. LIMITATION ON BENEFITS

Article 17 ensures that the source basis tax benefits granted by a Contracting State pursuant to the Convention go to the intended beneficiaries – residents of the other Contracting State – and are not extended to residents of third States not having a substantial business in, or business nexus with, the other Contracting State. For example, a resident of a third State might establish an entity resident in a Contracting State for the purpose of deriving income from the other Contracting State and claiming source State benefits with respect to that income. Absent Article 17, the entity

would generally be entitled to benefits as a resident of a Contracting State, subject, however, to such limitations (e.g., business purpose, substance-over-form, step transaction, or conduit principles) as may be applicable to the transaction or arrangement under the domestic law of the source State. The Article is intended to strengthen and expand the anti-treaty shopping rules provided by the "beneficial owner" phrases contained in other Articles of the Convention by addressing situations where the beneficial owner is not an individual.

Paragraph 1 provides for seven "safe harbor" tests which entitle residents of a Contracting State to treaty benefits. Only one of these safe harbor tests need be passed for a resident to be entitled to the benefits of the Convention.

Under the first test, all individuals who are residents of either Contracting State are entitled to the benefits of the treaty, without further examination. Under the second test, the Contracting States themselves along with their political subdivisions and any wholly-owned government instrumentalities are treated the same as individual residents of the Contracting States and accorded full benefits under the Convention.

The third safe harbor test deals with non-profit organizations. Non-profit organizations and comparable public institutions organized for religious, charitable, scientific, literary, or educational purposes are entitled to the benefits of the treaty. It is understood that whether an organization is non-profit and organized for the stated purposes is to be determined by the tax law of the Contracting State in which the relief from taxation is being sought. It is contemplated that this safe harbor test will cover such institutions as the Red Cross which might not otherwise be covered by the safe harbor tests.

The fourth test deals with tax-exempt organizations, other than the non-profit organizations covered by the third test. Provision 13 of the Protocol describes such tax-exempt organizations as including, but not limited to, pension funds, pension trusts, private foundations, trade unions, trade associations, and similar organizations. Such an organization, which is granted tax exempt status under the domestic law of a Contracting State, is entitled to the benefits of the Convention if more than half of such organization's beneficiaries, members, or participants are themselves entitled to the benefits of the Convention. For example, agricultural cooperatives which are exempt from tax in the United States under Code section 521 would be entitled to relief from taxation under the Convention if more than half of the participants in the cooperative were individual residents of the United States. Notwithstanding this participation rule, provision 13 of the Protocol provides that in the case of pension funds and trusts, such entities are entitled to the benefits of the Convention if the organization (employer) sponsoring the pension fund is itself entitled to the benefits of the Convention, regardless of whether the employees or pensioners are entitled to benefits. Thus, a tax-exempt pension fund can achieve entitlement to benefits through the status of either the employer or the employee-pensioners.

The fifth safe harbor test grants persons - other than individuals - conducting an active trade or business in the Contracting State of which they are a resident entitlement to relief from taxation with respect to income derived from the other Contracting State which is derived in

connection with, or is incidental to, the active conduct of that trade or business (except when that trade or business is the business of making or managing investments and the person is not a bank or insurance company). For the purpose of this test, the income need not be attributable to a permanent establishment in the Contracting State in which the income arises; it need only be derived by a resident of a Contracting State in connection with, or be incidental to, the active conduct of a trade or business in that Contracting State.

The sixth safe harbor test states that a company is entitled to benefits if there is substantial and regular trading in its principal class of shares on a recognized stock exchange. The sixth test also covers a company in which more than 50 percent of each class of its stock is owned by another company 1) which is a resident of the same Contracting State and 2) in whose principal class of shares there is substantial and regular trading on a recognized stock exchange. A recognized stock exchange is defined in paragraph 3 to mean: (1) the Spanish stock exchanges; (2) the NASDAQ System, owned by the National Association of Securities Dealers, Inc.; (3) any stock exchange registered with the Securities and Exchange Commission as a national securities exchange for purposes of the Securities Exchange Act of 1934; and (4) any other stock exchange which the competent authorities agree is a recognized exchange.

The final safe harbor test grants treaty benefits to residents who satisfy both of two specific conditions. First, more than 50 percent of the beneficial interest in the resident must be owned, directly or indirectly, by any combination of the Contracting State themselves (or local subdivisions thereof), U.S. citizens, individual residents of the United States or Spain, and persons entitled to the benefits of the Convention under the third, fourth, or sixth safe harbor tests described above. In the case where the resident is a company, the fifty percent beneficial ownership condition means more than 50 percent of the number of shares in each class of the company's shares of stock. Second, the gross income of the resident may not be used in substantial part, directly or indirectly, to meet liabilities to persons who are not residents of either Spain or the United States, are not citizens of the United States, are not the Contracting States themselves (or local subdivisions thereof), and are not entitled to the benefits of the Convention under the third, fourth, or sixth safe harbor tests. The term "liabilities" as used in this base erosion condition refers to deductible payments, which includes liabilities for interest and royalties. The term "substantial" is not defined. In general, deductible payments which are less than 50 percent of the relevant income are understood not to be considered substantial; however, in appropriate circumstances a lower percentage of income may be considered substantial. The term "gross income" is defined in paragraph 4 to mean gross receipts less, in the case of manufactured goods, the cost of labor and goods sold.

An alternative is provided by paragraph 2 for those persons not entitled to benefits of the Convention under one of the safe harbor tests. Under the provisions of paragraph 2, a person may be granted the benefits of the Convention if that person can demonstrate entitlement to benefits to the competent authority of the Contracting State in which the income arises. For this purpose, one of the adverse factors the competent authority is to consider is whether one of the principal purposes underlying the establishment, acquisition, and maintenance of such person and the conduct of its operations was obtaining benefits under the Convention.

Article 17 is not intended to impose any additional burden on the withholding agents of the Contracting States, and withholding agents will not be required to verify the accuracy of a person's claim to treaty benefits. In applying Article 17, the normal burden of proof rules apply. In claiming U.S. benefits, a resident of Spain would follow the normal U.S. procedures, in effect at the time, for claiming reduced rates of tax or exemption under a U.S. tax treaty. The Internal Revenue Service, of course, retains the right to consider, on audit, whether any particular grant of benefits was appropriate.

Article 18. DIRECTORS' FEES

Article 18 provides that fees for services rendered outside of a Contracting State by a resident of that Contracting State as a director of a company which is a resident of the other Contracting State may be taxed in that other Contracting State. The Article also covers payments for services substantially equivalent to those provided by the board of directors of a company. As Article 18 does not confer an exclusive right to tax, it is not necessary to invoke the saving clause of paragraph 3 of Article 1 (General Scope) for the United States to tax director's fees received by a U.S. resident or citizen from a Spanish company.

Article 18 differs from the U.S. Model, in which the United States takes the position that directors' fees should be covered by Article 15 (Independent Personal Services). Instead, the Article follows the OECD Model with the exception that the services performed in the Contracting State of which the director is a resident may not be taxed by the other Contracting State. Thus, services rendered in Spain or in a third State by a resident of the United States in his position as a director of a Spanish company may be taxed in Spain on account of the residence of the company; such income is foreign source income, so U.S. tax may be offset by a credit for tax imposed by Spain in accordance with Article 24 (Relief from Double Taxation). On the other hand, if such services are rendered in the United States, Spain may not tax such services solely on the basis of the residence of the company.

Article 19. ARTISTES AND ATHLETES

Article 19 addresses the taxation of income derived by a resident of a Contracting State as an entertainer, musician, or athlete from the performance of services as such in the other Contracting State (state of performance). Paragraph 1 explicitly overrides the provisions of Article 15 (Independent Personal Services) and Article 16 (Dependent Personal Services), if they would not otherwise permit such taxation, to allow the state of performance to tax such income so long as the gross receipts for such services exceeds \$10,000 (or its equivalent in Spanish pesetas) in the taxable year. If such gross receipts, defined to include expenses reimbursed to, or borne on behalf of, the artiste or athlete, exceed \$10,000 per year, the full amount, not just the excess, is subject to tax by the state of performance. By way of example, the term "entertainer" is defined to include theatre, motion picture, radio, or television artistes. Income derived from services rendered by persons such as producers, directors, technicians, and others who are not artistes or athletes is taxable in accordance with the provisions of Articles 15 or 16, as the case may be.

Provision 14 of the Protocol clarifies that the \$10,000 threshold provided for in paragraph 1 does not preclude the imposition of withholding taxes in the state of performance. In cases where withholding taxes are imposed, the provisions of paragraph 1 are to be implemented by refunding, after the close of the taxable year, any excess taxes withheld. If domestic law so provides, withholding agents will withhold taxes regardless of the provisions of Article 19 and it will be up to the artiste or athlete to file a claim for the refunding of any taxes withheld which would result in taxation not in accordance with the provisions of the Article.

Paragraph 2 covers cases in which income in respect of the activities of an entertainer or athlete is diverted to a person other than the entertainer or athlete; e.g., where the entertainer performs services as an employee of, or a contractor for, a corporation or other person. Paragraph 2 provides that when an artiste or athlete retains a beneficial interest in income in respect of his personal activities which is assigned or accrues to the benefit of another person, including a company, trust, or partnership, then such income may be taxed, notwithstanding the provisions of Articles 7 (Business Profits) and 15 (Independent Personal Services), in the Contracting State in which the activities of the entertainer or athlete take place. That is, enterprises receiving such income may be taxed in the state of performance, irrespective of whether they have a permanent establishment therein, and individuals receiving such income may be taxed in the state of performance, irrespective of whether they have a fixed base therein.

For purposes of paragraph 2, an artiste or athlete is considered to retain a beneficial interest in performance income assigned or accruing to another person unless the artiste or athlete establishes that neither he, nor any person related to him, participates directly or indirectly in the profits of such other person in any manner, including the receipt of deferred compensation, bonuses, fees, dividends, partnership distributions, or other distributions. A person may be considered related to the artiste or athlete regardless of whether that person would be considered to be related to him under the provisions of Article 9 (Associated Enterprises).

Paragraph 3 provides a general exception to the provisions of paragraphs 1 and 2 for performances supported by public funds. Paragraph 3 provides that when the activities in a Contracting State of the artiste or athlete (who is a resident of the other Contracting State) are substantially supported by public funds provided by the other Contracting State (or any subdivision thereof), the income from such public performances is exempt from tax in the first-mentioned Contracting State (state of performance). That is, the Contracting States have agreed not to tax the performance income of residents of the other Contracting State when such performances are substantially paid for by that other Contracting State. It is understood that the competent authorities may consult as to which visits meet this standard.

Article 19 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that the United States may tax its citizens and residents on performance income without regard to the Convention. Specifically, it means that the \$10,000 threshold does not apply when the United States taxes performance income derived by a resident of Spain if that performer is a U.S. citizen. It also means that the exemption from taxation of certain benefit performance income provided in paragraph 3 does not apply in determining the U.S. tax liability of a U.S. citizen.

Article 20. PENSIONS, ANNUITIES, ALIMONY, AND CHILD SUPPORT

Article 20 provides rules concerning the taxation of pensions, social security payments, annuities, alimony, and child support. However, the taxation of pensions in respect of governmental services rendered to a Contracting State is covered by the provisions of Article 21 (Government Service). Paragraph 1(a) grants an exclusive taxing right with respect to pensions and other similar remuneration paid to a resident of a Contracting State in consideration of past employment to that State regardless of where the past employment occurred. Paragraph 1(b) provides that social security payments paid to a resident of a Contracting State by the other Contracting State, regardless of whether or not paid in consideration of past employment, may be taxed in the other Contracting State. Provision 15 of the Protocol defines social security payments to include other pensions paid from publicly administered funds for non-governmental services, such as railroad retirement benefits provided for in the Railroad Retirement Act of 1974 (45 U.S.C. 231n). As paragraph 1(b) does not confer an exclusive right to tax, it is not necessary to invoke the saving clause of paragraph 3 of Article 1 (General Scope) for the Contracting State of which the recipient of the social securities payments is a resident to tax such payments. Social security payments may be taxable in both Contracting States, with the State of the recipient's residence allowing relief from double taxation under the provisions of Article 24 (Relief from Double Taxation) for any taxes imposed by the Contracting State in which such payments arise.

Paragraph 2 grants an exclusive taxing right with respect to annuities beneficially derived by a resident of a Contracting State to that State. The term annuities is defined to mean a stated sum paid periodically at stated times during a specified time period, under an obligation to make the payments in return for adequate and full consideration (other than for services rendered). Payments for services rendered are either employment income, such as the income covered by Articles 15 (Independent Personal Services) and 16 (Dependent Personal Services), or pensions, which are covered by paragraph 1(a) of Article 20 or paragraph 1 of Article 21 (Government Service).

Paragraph 3 provides that alimony paid to a resident of a Contracting State is taxable only in that State. The term alimony is broadly defined and is intended to include all periodic payments legally required to be paid as a result of a divorce or separation (other than child support payments), provided such payments are taxable in the hands of the recipient in his state of residence. Thus, if a United States resident divorcee receives alimony payments from a Spanish former spouse, Spain may not impose tax on those payments, as, under U.S. law, they are taxable in the United States as income of the recipient.

Paragraph 4 provides that child support payments received by a resident of a Contracting State may not be taxed by that Contracting State when they are paid by a resident of the other Contracting State. As with alimony, child support payments are broadly defined and are intended to include all periodic payments legally required to be paid for the support of minor children as a result of divorce or separation. By prohibiting the state of residence of the recipient from taxing such payments, the Convention ensures that the full amount received is available for the support of the minor children.

With the exception of paragraph 4, Article 20 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope), so that, in general, the United States may tax its citizens and residents on pensions, annuities, and alimony without regard to any restriction in Article 20. However, paragraph 4, by virtue of paragraph 4(a) of Article 1, is not subject to the saving clause. Thus, domestic law cannot overrule the exemption from tax in the state of residence of the recipient for child support payments provided for in paragraph 4.

Article 21. GOVERNMENT SERVICE

Article 21 applies to remuneration paid by a Contracting State (or political subdivision or local authority thereof) in respect of services rendered to that State (or political subdivision or local authority). Paragraph 1 applies to remuneration, other than pensions, for governmental service, and paragraph 2 applies to pensions arising from such governmental service.

Paragraph 1(a) grants an exclusive taxing right for remuneration in respect of governmental service to the Contracting State (or political subdivision or local authority thereof) for which such services are rendered, regardless of who renders such services or where such services are rendered.

Paragraph 1(b) provides an exception to paragraph 1(a) and grants an exclusive taxing right for remuneration for governmental services to the State in which such services are rendered provided that the recipient is a resident of that State and is either a national of that State or did not become a resident solely for the purpose of rendering the services. Thus, if a Spanish resident renders services to the U.S. Government in Spain, Spain is granted the exclusive right to tax such services if the recipient is either a Spanish national or did not become a Spanish resident solely for the purpose of providing such services.

Paragraph 2(a) grants an exclusive taxing right for any pension paid in consideration for past governmental services to the Contracting State (or political subdivision or local authority thereof) to which such services are rendered. Paragraph 2(b) provides an exception to paragraph 2(a) and grants an exclusive taxing right for such pensions to the Contracting State of which the recipient is a resident and national thereof. Note that paragraph 2(b) is only applicable when the recipient is both a resident and a national of the Contracting State. Thus, the United States is granted the exclusive taxing right to the Spanish national who retires to the United States and receives a pension resulting from services rendered to the U.S. Government.

Under the provisions of paragraph 3, payments for (and subsequent pensions arising from) services which are rendered in connection with a business carried on by a Contracting State, political subdivision or local authority, are, as appropriate, dealt with by the provisions of Articles 15 (Independent Personal Services), 16 (Dependent Personal Services), 18 (Directors' Fees), 19 (Artistes and Athletes), and 20 (Pensions, Annuities, Alimony, and Child Support). It is understood that determinations of whether remuneration is for services (1) rendered to a Contracting State (or political

subdivision or local authority thereof) or (2) rendered in connection with a business carried on by a governmental agency or authority is to be made by reference to the laws of the State in which the income arises.

Article 21 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope) as modified by paragraph 4 of Article 1. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of the Article which would grant exclusive taxing rights to Spain with respect to remuneration and subsequent pensions earned by (1) persons employed by Spain and (2) Spanish resident nationals employed by the United States Government in Spain are overridden by the saving clause if the employees are U.S. citizens or green card holders.

Article 22. STUDENTS AND TRAINEES

Paragraph 1 of Article 22 provides that a resident of a Contracting State who visits the other Contracting State for the primary purpose of studying at an accredited educational institution, securing training in a professional speciality, or engaging in research of an educational nature shall be exempt from taxation in that Contracting State with respect to certain items of income during such period of study, research, or training. Paragraph 1(b) defines those exempt items of income as 1) payments from abroad, other than compensation for personal services, for maintenance, education, study, research, or training; 2) grants, allowances, or awards from a governmental, religious, charitable, scientific, literary, or educational institution funding the research or studies; and 3) income from personal services performed in that other Contracting State to the extent of \$5,000 (or the equivalent in Spanish pesetas) per taxable year. The exemptions provided in paragraph 1 are available to the visiting student or trainee for a period not exceeding five years from the beginning of the visit.

The second paragraph of the Article provides an exemption for residents of a Contracting State who are employed by, or under contract with, a resident of the same Contracting State and who temporarily visit the other Contracting State for the purpose of studying at an accredited educational institution or acquiring technical, professional, or business training or experience in that other Contracting State, provided such training is from a person other than the employer or contractor. Such student or trainee is exempt from taxation in the other Contracting State for a period of twelve consecutive months on personal services income to the extent of \$8,000 (or the equivalent in Spanish pesetas) during that period.

Provision 16 of the Protocol provides that the \$5,000 exemption in paragraph 1 and the \$8,000 exemption in paragraph 2 include any amount excluded or exempted from taxation under the domestic law of the Contracting State in which the exemption applies. Thus, in the case of the United States, the amounts include the Code section 151 personal exemption amount (\$2,000 for taxable years beginning after December 31, 1988).

The Article concludes with a provision that the exemptions provided do not apply to income from research if such research is undertaken primarily for the private benefit of a specific person or persons. For example, personal service income arising from research at a corporate research facility would, in general, not qualify as exempt income.

The benefits conferred by the other Contracting State under Article 22 are subject to the provisions of the saving clause in paragraph 3 of Article 1 (General Scope) as modified by paragraph (b) of Article 1. With respect to the United States, the modified saving clause applies to U.S. citizens and persons having immigrant status in the United States ("green card" holders). Thus, the provisions of paragraph 1 which would exempt a Spanish resident from taxation as a student in the United States are overridden by the saving clause if that student is a U.S. citizen or green card holder. On the other hand, if a student (who is not a citizen or a green card holder) acquires residence in the United States for tax purposes during that period of study or training, he will be exempt from tax in the United States on those certain items of income.

Article 23. OTHER INCOME

With respect to any income which is received by a resident of a Contracting State and is not dealt with in the foregoing Articles of the Convention ("other income"), paragraph 1 of Article 23 grants an exclusive right to tax such "other income" to that State (state of residence). This rule applies not only to income of a class not expressly dealt with, such as prizes, awards, or gifts, but also to income from sources not expressly mentioned. The scope of the Article is not confined to income from the Contracting States, but applies, as well, to income arising in third States.

Paragraph 2 provides, as an exception to the exclusive taxing right granted in paragraph 1, that, if the beneficial owner of such "other income" carries on business in the other Contracting State through a permanent establishment or fixed base situated therein and the income is attributable to such permanent establishment or fixed base, that "other income" is taxable in that other State in accordance with the provisions of Article 7 (Business Profits) or Article 15 (Independent Personal Services), rather than under the provisions of paragraph 1. Thus, for example, income of a U.S. resident which arises in a third State and which is attributable to a permanent establishment of such person in Spain may be taxed by Spain under the provisions of Article 7.

However, paragraph 2 does not provide an exception to the exclusive taxing right granted in paragraph 1 to the state of residence with respect to income from real (immovable) property, as defined in paragraph 2 of Article 6 (Income from Real Property), for which the state of situs of the property has a primary right to tax. Thus, "other income" derived from real property remains taxable only in the state of residence of the recipient even if the recipient (beneficial owner) maintains a permanent establishment (or fixed base) in the other Contracting State and that real property forms part of the business property of that permanent establishment or fixed base. This is not inconsistent with the rules laid down in Article 13 (Capital Gains) since paragraph 3 of that article only applies to the personal (movable) property of a permanent establishment.

Article 23 is subject to the provisions of the saving clause of paragraph 3 of Article 1 (General Scope). so that, in general, the United States may tax "other income" of U.S. residents and citizens without regard to the Convention. Specifically, this means that, irrespective of the exclusive right to tax granted to the state of residence in paragraph 1. the United States also may tax "other income" received by a resident of Spain if that resident is a U.S. citizen.

Article 24. RELIEF FROM DOUBLE TAXATION

Paragraph 1(a) of Article 24 provides that, subject to the provisions and limitations of Spanish law regarding the allowance of foreign tax credits, Spain will allow to a resident of Spain as a deduction against Spanish tax on income (i.e., as a credit) the appropriate amount of income tax actually paid to the United States. The amount of credit for U.S. taxes granted under the Convention is explicitly limited to that part of the income tax computed in Spain, before the paragraph 1(a) credit is granted, which is attributable to the income derived from the United States.

Paragraph 1(b) modifies the provisions of paragraph 1(a) to allow an additional credit with respect to dividends arising from a substantial holding by a company, to relieve taxation of such dividends at both the subsidiary and parent levels. In the case of dividends paid by a U.S. company to a Spanish company which directly owns at least 25 percent of the U.S. company, paragraph 1(b) provides that, in addition to the credit granted by paragraph 1(a), a credit shall be allowed for the part of the tax effectively paid by the U.S. company on the profits out of which the dividends are paid, provided that such amount of tax is included in the taxable base of the Spanish company. The 25 percent or greater participation must be held on a continuous basis during 1) the taxable year in which the dividends are paid, and 2) during the previous taxable year. Provision 17 of the Protocol provides that, in the case of a company created during the taxable year preceding the payment of the dividend, the previous taxable year is deemed to begin on the date of creation of such company.

Paragraph 1(c) provides a rule which allows Spain to take into account income exempted from tax in Spain by provisions of the Convention in calculating Spanish taxes on the non-exempt income of residents of Spain. That is, Spain will determine the average rate of tax applicable as if the total income were taxable and apply that rate to the taxable portion (or forgive that rate times the exempt portion).

Paragraph 2 provides that, subject to the provisions and limitations of U.S. law, the United States shall grant a foreign tax credit for the appropriate amount of income taxes paid or accrued to Spain. Paragraph 2 provides a credit both for Spanish taxes imposed on a recipient of income arising in Spain and, in the case of a U.S. company owning at least 10 percent of the voting stock of a company resident in Spain from which the U.S. company receives dividends in the taxable year, the appropriate amount of Spanish taxes paid or accrued by the Spanish company with respect to the profits out of which it paid the dividends. The latter "indirect" credit would not be available with respect to dividends from a dual resident corporation.

Paragraph 3 provides that, when the United States invokes the saving clause contained in paragraph 2 of Article 1 (General Scope) to tax a U.S. citizen resident in Spain, the income so taxed will be deemed to arise in Spain to the extent necessary to avoid double taxation. This provision overrides U.S. law source rules only in those cases where U.S. law would operate to deny a foreign tax credit for taxes imposed by Spain under the provisions of the treaty on U.S. citizens resident in Spain. In no case, however, is this provision to reduce the taxes paid to the United States below those that would be paid if the individual were not a citizen of the United States. That is, the United States tax imposed on a non-resident, non-citizen with respect to income arising in the United States.

As an example of the application of paragraph 3, consider a U.S. citizen resident in Spain who receives \$200 of interest income from United States sources. Under the provisions of Article 11 (Interest), the United States may impose a withholding tax of 10 percent on interest payments made to residents of Spain, in this case resulting in \$20 of tax. Spain may then tax the income of its resident granting, in accordance with the provisions of paragraph 1 of this Article, a credit for the U.S. taxes imposed on the basis of source of income. When the United States then taxes that person as a U.S. citizen, it must provide for re-sourcing of that interest income so as to allow a foreign tax credit for the Spanish taxes imposed but only to the extent necessary to avoid double taxation of that income and, in no case, to reduce the U.S. taxes paid below the \$20 withheld at source. When the Spanish tax exceeds the U.S. source tax, the income is re-sourced, but only to the extent necessary to offset the additional U.S. tax imposed on account of citizenship. A foreign tax credit is granted for those additional Spanish taxes but no excess foreign tax credits are to be generated. This situation will only arise when the Spanish tax imposed on account of residence is more than the U.S. tax allowable under the Convention (Article 11 in this example).

By reason of paragraph 4(a) of Article 1 (General Scope), Article 24 is not subject to the provisions of the saving clause of paragraph 3 of Article 1. Thus, the saving clause cannot be used to deny a Spanish resident the benefit of the credits provided for in paragraph 1 or to deny a U.S. citizen or resident the benefit of the credits provided for in paragraphs 2 and 3.

Article 25. NON-DISCRIMINATION

Paragraph 1 of Article 25 provides that nationals of a Contracting State (as defined in paragraph 1(g) of Article 3 (General Definitions)) shall not be treated less favorably with respect to taxation and connected requirements by the other Contracting State than are nationals of that other Contracting State in the same circumstances. This provision applies to a national of a Contracting State, whether or not that person is a resident of either Contracting State. A national of the United States who is not a resident of the United States is understood to be in different circumstances from a national of Spain who is not a resident of the United States as the United States taxes non-resident nationals on worldwide income but does not tax non-resident Spanish nationals on worldwide income. Thus, the United States is not obliged to treat a national of Spain who is a resident of Spain or a third State in the same manner as a United States national who is a resident of Spain or that third State.

Paragraph 2 provides that a Contracting State may not impose more burdensome taxes on a permanent establishment which is maintained by an enterprise of the other Contracting State in that State than the first-mentioned State imposes on its own enterprises carrying on the same activities. The paragraph concludes with a provision to clarify that only the permanent establishment is protected from discrimination, not the beneficial owners. Those owners must look to other provisions of the Article, such as paragraphs 1 and 5, for protection from discrimination. For example, individuals owning a permanent establishment in a Contracting State who are residents of the other Contracting State need not be allowed the same personal exemptions and deductions granted by the first-mentioned Contracting State to its residents, as its residents are often taxable on their worldwide income whereas the permanent establishment's owners are taxable only on income attributable to the permanent establishment.

Paragraph 3 confirms the rights of the Contracting States to impose a branch tax as provided for in Article 14 (Branch Tax).

Paragraph 4 prohibits discrimination in the matter of deductions. Interest, royalties, and other disbursements paid by an enterprise of a Contracting State to a resident of the other Contracting State must be deductible for determining taxable profits in the first-mentioned State under the same conditions as if they had been paid to a resident of the first-mentioned State. Exceptions to this rule arise where the provisions of paragraph 1 of Article 9 (Associated Enterprise), paragraph 7 of Article 11 (Interest), or paragraph 6 of Article 12 (Royalties) apply.

Paragraph 5 requires that a Contracting State not impose more burdensome taxation on an enterprise of that State owned by residents of the other Contracting State than it imposes on similar enterprises owned by its own residents.

Paragraph 6 specifies that the scope of Article 25 extends to all taxes of every kind and description imposed by a Contracting State or political subdivision or local authority thereof, even though Article 2 (Taxes Covered) only specifies national income taxes and selected excise taxes. In the case of the United States, this means that state and local income taxes as well as estate and gift, excise, and property taxes are covered by the non-discrimination provisions.

By reason of paragraph 4(a) of Article 1 (General Scope), Article 25 is not subject to the provisions of the saving clause of paragraph 3 of Article 1. Thus, the saving clause cannot be used to deny a resident or citizen of the United States or Spain the benefits of the non-discrimination provisions of Article 25.

Article 26. MUTUAL AGREEMENT PROCEDURE

Paragraph 1 of Article 26 provides that, if a person believes he is, or will be, subject to taxation not in accordance with the Convention as a result of actions of one or both of the Contracting States, then such person may present his case to the competent authority of the State of which the person is a resident or national. The person need not first have exhausted the remedies

available to him in the domestic laws of the Contracting States. The use of the term "person", rather than "resident of a Contracting State," is intentional, as non-resident nationals of Contracting States have access to the mutual agreement procedure with respect to the provisions of Article 25 (Non-Discrimination). The case must be presented within five years from the first notification of the action resulting in taxation not in accordance with the provisions of the Convention. Provision 18 of the Protocol defines "first notification of the action resulting in taxation" to mean the Code section 6212 Notice of Deficiency in the case of the United States and the Notification of the Administrative Act of Assessment in the case of Spain. In the case of taxes at source, the "first notification" is the date on which the tax is withheld or paid.

Paragraph 2 provides that, when the competent authority of a Contracting State considers the case raised under the provisions of paragraph 1 to be justified and is unable to arrive at a satisfactory solution itself, it shall endeavor to resolve the case by mutual agreement with the competent authority of the other Contracting State so as to avoid taxation not in accordance with the Convention. Any agreement reached by the competent authorities with respect to that case shall be implemented without regard to any statutory time limits or other procedural limitations of the Contracting States, provided the conditions of paragraph 1 are satisfied. Thus, if it is agreed that a taxpayer's liability should be adjusted downward, a refund of the excess tax paid will be made even if the statute of limitations of the State called upon to make the refund may have expired. It is understood that this waiver of the statute of limitations will be applied only for refunds and not for the imposition of additional taxes.

Paragraph 3 provides that the competent authorities shall endeavor by mutual agreement to resolve any difficulties or doubts which may arise as to the interpretation or application of the Convention. They may also consult together to eliminate double taxation in cases not specifically provided for in the Convention. For example, the competent authorities may mutually agree 1) upon the attribution of income, deductions, credits, or allowances between persons or between an enterprise of a Contracting State and its permanent establishment in the other Contracting State; 2) upon the characterization of items of income as interest, dividend, royalty, rent, etc.; 3) upon the application of source rules; and 4) upon a common meaning for any term used in the Convention. And the competent authorities may agree upon the procedures necessary to implement the limitations on withholding of taxes at source as provided in Articles 10 (Dividends), 11 (Interest), and 12 (Royalties).

Paragraph 4 provides that the competent authorities may communicate with each other directly, that is, outside of normal diplomatic channels of communication, for the purpose of reaching agreement in accordance with Article 26. Any such communications containing taxpayer information are covered by the provisions of Article 27 (Exchange of Information and Administrative Assistance), including the confidentiality provision of paragraph 1.

By reason of paragraph 4(a) of Article 1 (General Scope), Article 26 is not subject to the provisions of the saving clause of paragraph 3 of Article 1. Thus, the saving clause cannot be used to deny a citizen or resident of the United States or Spain the benefit of seeking redress through the competent authorities for taxation perceived to be in violation of the provisions of the Convention.

Article 27. EXCHANGE OF INFORMATION AND ADMINISTRATIVE ASSISTANCE

Paragraph 1 of Article 27 provides that the competent authorities shall exchange such information as is necessary for carrying out the provisions of the Convention. The competent authorities shall also exchange such information as is necessary to carry out the provisions of domestic tax law, such as to prevent tax evasion or fraud, so long as the tax is covered by the Convention and the resulting taxation is not contrary to the Convention. The information to be exchanged is not limited by the provisions of Article 1 (General Scope), but may pertain to residents or nationals of third States. It is understood that the information to be exchanged is not limited to the covered taxes listed in Article 2 (Taxes Covered), but pertains to taxes of every kind imposed by the Contracting State (all national level taxes), provided such information is necessary for carrying out provisions of the Convention, or domestic law, pertaining to the covered taxes. It is understood that the phrase "such information as is necessary" is to be interpreted so as to obligate a state to provide requested information even if it does not relate to a tax liability in the requested State. Furthermore, it is understood that a Contracting State, to the maximum extent possible, will provide the requested information in the form necessary to satisfy the purposes of the request. For example, when specifically requested, a Contracting State will endeavor to provide information or documents in such a form so as to be admissible in judicial proceedings of the requesting State.

Paragraph 1 contains a confidentiality provision that requires that information so exchanged will be protected in the same manner as information obtained under domestic laws with respect to secrecy and disclosure. The use of such information is limited to those persons involved in the assessment, collection, or administration of, the enforcement or prosecution in respect of, or the determination of appeals in relation to, taxes covered in the Convention and those persons may use such information only for such stated purposes. Disclosure of any such information to persons other than those specifically mentioned is limited to public court proceedings or judicial decisions.

The provisions of paragraph 1 authorize the competent authorities to allow access to information to persons involved in the administration of taxes covered in the Convention. Such persons are understood to include legislative bodies involved in the administration of taxes and their agents, such as, for example in the United States, the General Accounting Office when it is engaged in a study of the administration of U.S. tax laws pursuant to a directive of Congress. However, the confidentiality provision of paragraph 1 still applies. Furthermore, access to information by persons involved solely in the administration of taxes is limited to that purpose, administration of taxes, and may not be used for any other purpose by those persons.

Paragraph 2 explains that paragraph 1 does not obligate the United States or Spain to carry out measures contrary to the laws and administrative practice of either State; to supply information not obtainable under the laws or in the normal course of the administration of either State; or to supply information which would disclose trade secrets or other information the disclosure of which would be contrary to public policy. Thus, Article 27 allows, but does not obligate, the United States and Spain to obtain and provide information which would not be available to the requesting State under its own laws or administrative practice or that in different circumstances would not be available to the State requested to provide information.

Provision 19 of the Protocol requires that Article 27 be interpreted in a manner consistent with the Commentary on the OECD Model. Furthermore, Provision 19 obliges the Contracting States to spontaneously exchange such information as is necessary to ensure that benefits of the Convention are granted only to persons entitled thereto. For example, when a Contracting State discovers that an "address of convenience" is being utilized by a third country resident to obtain the reduced withholding rates applicable to residents of that Contracting State, it shall notify the other Contracting State that such third country resident is not entitled to reduced rates.

Article 28. DIPLOMATIC AGENTS AND CONSULAR OFFICERS

Article 28 provides that this Convention shall not deny diplomats and consular officials any special taxation privileges granted to them under the rules of special agreements or international law. This provision confirms the provisions of paragraph 2 of Article 1 (General Scope) that the Convention does not restrict benefits otherwise available.

Additional tax benefits may be granted by the Convention, however, to diplomats and consular officials who are residents of one of the Contracting States. If so, any such benefits are subject to the provisions of the saving clause in paragraph 3 of Article 1 (General Scope) as modified by paragraph 4(b) of Article 1. Various other provisions of the Convention, not directly regarding taxation, may also apply to diplomatic agents and consular officers, such as those provisions concerning exchange of information, the mutual agreement procedure, and non-discrimination.

Article 29. ENTRY INTO FORCE

Paragraph 1 of Article 29 requires that the Convention be ratified by the Contracting States, in accordance with their applicable procedures, and that the instruments of ratification be exchanged in Washington as soon as possible.

Paragraph 2 provides that the Convention will enter into force on the date on which instruments of ratification are exchanged. The Convention shall then take effect, 1) with respect to taxes withheld at the source in accordance with the provisions of Articles 10 (Dividends), 11 (Interest), and 12 (Royalties), for amounts paid or credited on or after the first day of the second month following the date on which the Convention enters into force, and 2) with respect to all other covered taxes, for taxable years beginning on or after the first day of the next January following the date on which the Convention enters into force. Thus, if the instruments of ratification are exchanged on August 15, 1990, the Convention takes effect with respect to withholding taxes on October 1, 1990 and with respect to other taxes for taxable periods beginning on or after January 1, 1991.

Provision 20 of the Protocol contains a general commitment obliging the competent authorities to consult on possible modification of the Convention to reflect substantial changes by either Contracting State in its domestic legislation or in its tax relations with other States. Specific

reference is made to changes occurring by virtue of new developments in tax treaty policy and in supranational systems of integration. By inclusion of such a provision, the Contracting States express their intention to update the various provisions of the Convention, as necessary, to reflect changing circumstances affecting domestic law, treaty policy in general, and the Convention in particular. For example, it is understood that, if there is a modification in Spain's treaty policy with respect to withholding rates, the competent authorities will consult regarding the possible extension of that treaty policy to this Convention.

Article 30. TERMINATION

The Convention is to remain in force indefinitely unless terminated by one of the Contracting States in accordance with the provisions of Article 30. After the Convention has been in force for five years, either Contracting State may terminate the Convention by giving notice through formal diplomatic channels at least six months before the end of the last calendar year for which the Convention is to have effect. If such a notice of termination is given, the Convention shall cease to have effect for taxable years beginning on or after the first day of January of the calendar year following the expiration of the six month notification period. Thus, if notification of termination were given on October 1, 1997, termination would take effect on January 1, 1999.

It is understood that nothing in Article 30, which relates to unilateral termination of the treaty, is to be construed as preventing the United States and Spain from negotiating and entering into a new bilateral agreement that supersedes, amends, or terminates provisions of the Convention either prior to the expiration of the five year waiting period or without the six month notification period.

June 14, 1990