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MFN Clause Activated in Spain-Venezuela Tax Treaty

by Leopoldo Escobar

Venezuela has agreed to the inclusion of most favored nation (MFN) clauses in several of its tax treaties, the most recent example being its treaty with Spain. (For the English text of the Spain-Venezuela tax treaty, see *2003 WTD 126-13* or *Doc 2003-15660*; for the Spanish text of the treaty, see *Doc 2003-14680*.) The MFN clause in that treaty was indirectly activated in May 2006 as a result of a treaty protocol between Estonia and the Netherlands, illustrating the complex and sometimes problematic interaction of treaties with MFN clauses.

Background

MFN clauses are widely used in tax treaties, particularly when countries are reluctant to forgo their rights to tax some elements of income. Usually, during negotiations (mainly between developed and developing countries), one country will make specific concessions to the other, such as accepting high source taxes on interest, dividends, and royalties. In those cases, the conceding country often will ask for the inclusion of an MFN clause. The clause generally stipulates that if the country benefiting from the concession later agrees to a more favorable tax treatment with a third country, the more favorable treatment will automatically apply to the conceding country or, alternatively, the contracting countries will be required to immediately enter into negotiations with a view to include the more favorable treatment in the treaty as quickly as possible.

The object of the MFN clause is twofold. The principal goal is to guarantee that the country to which the promise is offered is not subjected to discriminatory treatment as compared with third countries that negotiate treaties afterward and are offered better treatment because of a change in policy, because they negotiated with more ability, or because they simply were in a better bargaining position. The second objective, from a practical standpoint, is to ensure the extension of the agreement to include any benefit later accorded to third countries without the need for extensive renegotiations.

Despite the importance of the clause and its frequent inclusion in tax treaties, none of the existing model treaties — such as those developed by the OECD, the United Nations, the Andean Community, or the U.S. Treasury Department — include a provision that can serve as a starting point for the negotiation of an MFN clause, much less elucidate any problems of interpretation or application arising after its inclusion in a tax treaty. Therefore, that void must be filled using the general principles of treaty interpretation and application to determine the scope and effects of MFN clauses.

Scope of MFN Clause

The original text of the Spain-Venezuela tax treaty establishes, under article 11, that interest may be subject to tax in the country of source up to 4.95 percent of the gross amount of interest in the case of financial institutions and 10 percent of the gross amount of interest in all other cases.

The protocol to the treaty contains an MFN clause applicable to the taxation of interest in the country of source that reads as follows:

> VII. Insofar as Article 11 is concerned: Where, after the signing of this Convention, a Contracting State enters into a Double-Taxation Convention with a member State of the European Union pursuant to which taxation is agreed upon which is lower than that set forth in Article 11, the provisions of the Convention signed later shall also apply, as of the date on which it comes into force and effect, to this Convention.

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A distinctive feature of the MFN clause in Venezuela's treaty with Spain is its bilateral reach. The wording of the clause clearly stipulates that it is automatically activated if, after the signing of the treaty (which took place on April 8, 2003), either Venezuela or Spain enters into a treaty (with an EU member country) that provides more favorable tax treatment of interest payments.

Activation of the MFN Clause

The MFN clause contained in Venezuela's treaty with Spain was activated by Spain's treaties with Estonia and Malta, as both of those treaties meet the conditions for the activation of the MFN clause, namely:

- they have been entered into with EU members by one of the contracting countries (Venezuela or Spain);
- they were entered into after the signing of the Spain-Venezuela treaty;
- they are in force; and
- they establish a lower taxation of interest.

First Activation: Estonia-Spain Treaty

This is a typical example of the problems that might arise in the interaction of treaties with MFN clauses. The Estonia-Spain treaty was signed on September 3, 2003, and entered into force on December 28, 2004. The treaty contains a unilateral MFN clause that is activated if Estonia enters into a treaty with an OECD member country that provides for more favorable tax treatment of interest payments.

The MFN clause in the Estonia-Spain treaty was activated on May 21, 2006, as a result of the protocol entered into between Estonia and the Netherlands (for prior coverage see *Tax Notes Int'l*, June 12, 2006, p. 958), which established that "interest arising in a Contracting State on a loan of whatever kind granted to an enterprise of that State by a bank of the other Contracting State shall be taxable only in that other State." In other words, the Estonia-Netherlands protocol established that interest payments to banks are not taxable in the country of source.

As a result of that protocol, the unilateral MFN clause in the Estonia-Spain treaty was directly activated and the bilateral MFN clause in the Spain-Venezuela treaty was indirectly activated. Consequently, as of May 21, 2006, any interest payments to banks are exempt from taxation in the country of source under those two treaties.

Second Activation: Malta-Spain Treaty

Spain and Malta signed a tax treaty on November 8, 2005, and it entered into force on September 12, 2006, establishing that "interest arising in a contracting State and paid to a resident of the other Contracting State shall be taxable only in that other State." In other words, interest is taxable only in the country of residence of the recipient. (For the English text of the treaty, see *2006 WTD 185-11* or *Doc 2006-19928*; for the Spanish text of the treaty, see *Doc 2006-19071*.)

The bilateral MFN clause in Venezuela's treaty with Spain was directly activated by Spain's treaty with Malta. As a result, as of September 12, 2006, article 11 of the Spain-Venezuela treaty was automatically amended to provide that all interest paid by a Venezuelan resident to a Spanish resident and vice versa is taxable only in the recipient's country of residence.

Conclusion

It is unclear whether the bilateral reach of the MFN clause in Venezuela's treaty with Spain was intended by the Venezuelan tax officials in charge of negotiating that treaty. Nevertheless, a proper interpretation of the clause leads to that result.

It was not hard to imagine that Spain's execution of a more favorable tax treaty with another EU member country would lead to the activation of the MFN clause, given the tendency in the European Union to eliminate interest withholding in the source country for payments between associated companies (in the context of the EU interest and royalties directive (2003/49/EC)).

As a result of the activation of its MFN clause, Venezuela's treaty with Spain has undoubtedly become the most favorable tax treaty executed by Venezuela to date. The combination of the tax exemption for dividends and interest and the favorable holding regime existing under Spain's domestic legislation makes Spain an excellent home office location for foreign investors wishing to invest in Venezuela. ◆

♦ *Leopoldo Escobar, Hogan & Hartson LLP, Caracas*