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Global Tax Alert

Spanish Central Tax Court applies doctrine of ECJ Danish cases to deny withholding tax exemption on dividend payments to EU shareholders

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Executive summary

The Spanish Central Tax Court issued a Decision on 8 October 2019 (the Decision), recently published, confirming the rejection of the withholding tax exemption for dividend payments by a Spanish company to a Luxembourg company on the basis that the latter is not the beneficial owner of such payments.

The Decision follows the beneficial ownership stance expressed by the European Court of Justice (ECJ) in the so-called Danish cases (See EY Global Tax Alert, *CJEU rules on application of Danish withholding tax on dividends and interest payments*, dated 26 February 2019). In particular, the Central Tax Court held that for the Spanish domestic exemption to apply, the recipient must be the beneficial owner of the relevant income.

The ultimate parent company of the multinational group to which both the Spanish subsidiary and the Luxembourg parent belong is a Qatari entity.

The Spanish Central Tax Court confirmed the correctness of a very strict interpretation taken by the Spanish tax audit of the Spanish anti-abuse rules affecting entitlement to Parent-Subsidiary Directive benefits and also rejecting treaty benefits.

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The result is that dividends paid by the Spanish subsidiary to its Luxembourg parent are subject to a 19% withholding tax provided for by the Spanish domestic legislation.

Detailed discussion

Background

A Luxembourg holding company (LuxCo) filed a reclaim requesting the refund of the dividend withholding taxes (WHTs) borne in Spain in 2013 and 2014. The Spanish company (SpainCo) distributing the dividend had applied the reduced 15% WHT rate under the Spain-Luxembourg tax treaty, signed in 1986.

LuxCo filed a reclaim afterwards, requesting the refund of WHTs borne on the grounds that the dividends obtained were exempt under the European Union (EU) Parent-Subsidiary Directive.

The Spanish tax authorities rejected the exemption under the EU Parent-Subsidiary Directive on the grounds that LuxCo was not the beneficial owner. Moreover, the application of the reduced 15% WHT under the treaty was also disallowed.

During 2013 and 2014, the Spain-Qatar tax treaty was not in force.

The Spanish implementation of the EU Parent Subsidiary Directive

The EU Parent-Subsidiary Directive (90/435/EEC) provides for a 0% withholding tax on dividends paid between entities resident in EU Member States under certain conditions.

The EU Parent-Subsidiary Directive, as implemented by Spain, does not expressly include the requirement that the recipient of the dividend be the beneficial owner. It does include an anti-avoidance provision that excludes the withholding tax exemption on distributions made to direct EU shareholders when the majority of the voting rights of the EU parent company are directly or indirectly owned by individuals or legal persons that are not EU residents.

However, in such case, under the wording of the Spanish tax rules in force until 2015, the 0% dividend withholding tax would still apply if one of the following conditions (the so-called "safe-harbors") is satisfied:

- The EU parent entity carries on a business activity directly related to the business activity of the Spanish subsidiary.
- The business purpose of the parent entity is the management of the subsidiary with the necessary organization of human and material resources.
- The parent entity may prove that it has been set up with a sound business purpose and not to unfairly benefit from the dividend withholding tax exemption.

Historically, these provisions have been strictly interpreted by the Spanish tax authorities and tax courts.

Spain-Luxembourg tax treaty

The Spain-Luxembourg tax treaty sets forth that dividends paid by a Spanish tax resident company to a Luxembourg tax resident company that is the beneficial owner of the dividends may benefit from the following reduced WHT rates:

- 10% of the gross amount of the dividends if the beneficial owner is a company (other than a partnership) which holds directly at least 25% of the capital of the Spanish company paying the dividends, if the beneficial owner is a company which has held the capital for a period of at least one year prior to the distribution of the dividends.
- 15% of the gross amount of the dividends in all other cases.

The Decision

LuxCo considered that it benefitted from the exemption on the grounds that it had been set up with a sound business purpose and not to unfairly benefit from the dividend WHT exemption (third safe harbor above).

The following are the main arguments raised by the tax authorities to evidence that LuxCo is not the beneficial owner of the income and that its incorporation was tax-driven:

- The legal address in Luxembourg belonged to an external service provider. Also, some directors were employees of this same service provider.
- LuxCo does not have employees.
- LuxCo is not the beneficial owner of the dividend because it repatriates funds on a yearly basis to its Qatari shareholder, sometimes by way of subsequent dividends and other times through repayment of debt. Also, the financing is structured via CPECs, which provide favorable tax treatment in Luxembourg.

In view of the tax authorities, the following facts do not change their analysis and conclusion:

- The investment in the Spanish company represented less than 50% over the total portfolio.
- LuxCo purchased the shares in the Spanish company a year and a half after its incorporation and had already made other investments in other jurisdictions.
- LuxCo had many other sources of income different from the dividends obtained from the Spanish company.
- LuxCo was focused on investments in the energy sector where, the non-tax rules applicable to EU shareholders are, at some point, different and more favorable from the applicable rules to third-countries shareholders.

In addition to the above, the tax authorities also denied access to DTT benefits under the argument that LuxCo was not the beneficial owner of the dividends, which is a requirement to have access to the benefits of the DTT.

In doing so, the Spanish tax authorities invoked the Commentaries to Article 1 of the 2010 OECD Model Tax Convention that state that "(…) it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions [referred to above]. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favorable tax position and obtaining that more favorable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions."

Implications

This resolution can be appealed before the Spanish judicial courts.

It remains to be seen whether the approach of considering beneficial ownership as a material requirement of the domestic exemption on dividend payments will be upheld in the future.

In particular, in the past the National High Court took the view that where the domestic exemption (for interest) does not expressly include the beneficial ownership clause, the exemption can only be challenged under Spanish General Anti-Avoidance Rules.

The Spanish Supreme Court has recently ruled on the limits of the dynamic interpretation of tax treaties (See EY Global Tax Alert, *Spanish Supreme Court rules on limits to dynamic interpretation of tax treaties*, dated 17 June 2020). It is also to be seen whether the interpretation of the 1986 Spain-Luxembourg tax treaty in light of the Commentaries to the 2010 Model Tax Convention will be upheld in judicial courts.

Notwithstanding the above, this resolution confirms the trend within the Spanish tax authorities and the Spanish administrative courts to challenge structures on the basis of the beneficial ownership clause as an independent anti-abuse rule, even if not included in the Spanish tax law, theoretically under the criteria established in the Danish cases and irrespective of the existence of other general anti-avoidance rules in the Spanish tax legislation.

For additional information with respect to this Alert, please contact the following:

Ernst & Young Abogados, Madrid

- Araceli Sáenz de Navarrete araceli.saenzdenavarretecrespo@es.ey.com
- Tatiana de Cubas Buenaventura tatianade.cubasbuenaventura@es.ey.com
- Manuel Paz manuel.pazfigueiras@es.ey.com
- Enrique Padilla joseenrique.padillagarcia@es.ey.com

Ernst & Young LLP (United States), Spanish Tax Desk, New York

- Jose A. (Jano) Bustos joseantonio.bustos@ey.com
- Isabel Hidalgo isabel.hidalgo.galache1@ey.com

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