Spanish Courts Confirm Interest Withholding Tax Exemption is Not Subject to Beneficial Ownership Test

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Being familiar with the Spanish tax environment, readers will know that Spain does not withhold taxes on interest paid to EU residents. This domestic exemption has been in force for several decades, long before the EU Interest and Royalties Directive.
The domestic exemption has the beauty of simplicity: it applies to all EU-resident lenders, without any further conditions. It has been applied without any issues since it was enacted and has allowed Spanish companies to access international financing without the increased costs that gross-up clauses bring to borrowers in high tax jurisdictions.

However, in the aftermath of the BEPs initiative, and the clear bias it has created against cross border transactions, some tax inspectors wanted to limit the scope of the exemption by interpreting it as being subject to a beneficial ownership test, despite the absence of this rule in the wording of the law.

As the Model Convention recognizes, the beneficial ownership test is probably one of the more ambiguous anti-abuse rules taxpayers can find. Tax inspectors and taxpayers seldom agree on when somebody is receiving an income as an agent or nominee or when a legal or contractual arrangement obliges the recipient to forward the payment to a third person. The main casualty of ill-written anti-abuse provisions is legal certainty.

Therefore, the recent judgment of the High Court of October 31, 2017, is a breath of fresh air. In this judgment, the court confirms several rulings of the lower instances, declaring that the Spanish interest withholding tax exemption is not limited by beneficial ownership provisions.

The case brought to the court related to the leveraged buyout of the Revlon group carried out by the Spanish company with a Luxembourg lender. The Luxembourg entity raised the funds by way of loans granted by CVC group through entities in the US and Jersey. This was a classic LBO transaction set up through Luxembourg, which the Spanish tax authorities challenged because of its base erosion effects in Spain (the borrower had no limits on the tax deductibility of the interest because the lender was an EU resident).

The tax inspectors denied the interest withholding tax exemption on the grounds that the Luxembourg lender was not the beneficial owner of the interest and paid most of it to its non-EU financiers. However, the Spanish High Court barred the challenge, confirming that the interest withholding tax exemption does not include this tax-treaty like clause.

The court reprimanded the tax inspectors for their misuse of anti-abuse provisions. The Spanish tax frame includes a general anti-abuse rule; therefore, if the tax inspectors thought the Luxembourg lender was part of a wholly artificial arrangement, they should have followed the special procedure for declaring tax abuse. That procedure is subject to certain procedural guarantees, which the tax auditors circumvented by applying the beneficial ownership rule.

The court's view that the beneficial ownership clause does not apply to the Spanish domestic exemption limits the potential denial of the benefit to extreme cases of abuse. Therefore, it will be difficult to deny in cases where the Spanish borrower is not related to the EU lender, as independent parties seldom participate jointly in tax abuse schemes.

While we wait for the final decision of the EU Court of Justice in the Danish beneficial owner cases,[fn]EU Court of Justice references C-115/16, 116/16, C-117/16, C-118/16, C-119/16 and C-299/16.[/fn] this Spanish judgment clarifies that Spain has voluntarily opted not to apply this type of clause in the domestic interest withholding tax exemption. This tax incentive should continue to apply, with the only exception being situations falling under the general anti-abuse rules, such as cases where the EU lender is a sham company or a totally artificial arrangement.