Local Management Moved Out of the Board!

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A recent decision of the Spanish Supreme Court, of February 26, 2018, in the civil law jurisdiction, may have an unexpected effect on the composition of the boards of directors of the Spanish subsidiaries of multinational groups. The practical effects for Spanish based groups with minority shareholders, where the role of directors is critical, could be very different.
This is an eminently domestic corporate law question which may end up putting on the table the debate regarding the tax residence of companies based on their effective place of management. Let me try to explain briefly this complex matter …

The Spanish Supreme Court has taken the view in various decisions that the relationship between individuals and a company, of which they are at the same time both directors and senior managers, is a mercantile relationship as opposed to an employment relationship (i.e. the position as director prevails). This is known in Spain as "bond doctrine" ("teoría del vínculo", in Spanish). Accordingly, where the bylaws of Spanish companies provide that the position of directors is not remunerated, any compensation received by those individuals is contrary to Spanish law and, consequently, not deductible for Corporate Income Tax purposes.

The bylaws of Spanish companies often state that the position of director is not remunerated, as this is what is provided by the Spanish Companies Act, unless the company bylaws explicitly stipulate otherwise. As most of these Spanish subsidiaries are 100% owned by a single shareholder (another group entity), nobody pays much attention to the bylaws of the local Spanish entity. Furthermore, local management personnel (CEO, CFO, COO …) are commonly

asked to be members of the board of the Spanish local entity (basically simply because “somebody needs to be there”). They do not receive any compensation for attending board meetings (which is what the company bylaws were actually referring to) but they are obviously well remunerated for their hard work as senior managers.

The outcome is that the Spanish Tax Agency is challenging the tax deductibility of the remuneration paid to the senior managers of Spanish companies. This is doubly painful: on one hand because local management remuneration is not low and the tax impact of its non-deductibility is far from being negligible; and on the other hand, it is hard for a company to accept that the remuneration of its senior managers is seen as a kind of gratuity which is contrary to the Spanish Companies Act.

Furthermore, this “bond doctrine” has concerning implications for managers, as they are better protected under an employment relationship than as directors. Labor Law protects “weak” employees, but Corporate Law tends to treat companies and directors as equals.

The way in which the Supreme Court, in its February decision, interprets the Companies Act as regards directors’ compensation will make compliance with its requirements more difficult going forward and will certainly mean that many companies are not currently complying with them (as the Supreme Court understands them).

Multinational groups are currently going in two possible and different directions: either they review and amend the bylaws of their Spanish 100%-owned affiliates in order to comply with the Corporate Law requirements as they are understood by the Supreme Court (which is not as simple as it may seem, among other reasons because this may confirm the relationship as directors vs their position as employees); or they move local management out of the board and replace them with other individuals or corporate directors who do not receive any remuneration from the Spanish entity.

These replacement directors (either individuals or corporates) will normally be non-resident in Spain and, if they are resident in another jurisdiction and the board meetings are to take place in that jurisdiction, there could be a concern – theoretically at least – regarding the location of the effective place of management

of the Spanish company and, as a consequence, whether this other jurisdiction could claim the tax residence of the Spanish entity. This should not be an issue, however, if the directors are resident in different countries and/or if the board meetings take place in Spain.

In brief, the Supreme Court decision could be welcomed by some Spanish local management personnel who may have been reluctant to become members of the board, as their groups are now likely to want them outside the board so they can be classed simply as senior employees. The implications for the future are nevertheless uncertain and, what is worse, may give rise in many cases, absurdly, to the non-deductibility of remuneration received by directors.