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## Spanish case law on tax treaties: real estate companies… or not

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Article 13.1 of the double tax treaty (DTT) signed between Luxembourg and Spain authorizes Spain to tax gains from the alienation of shares in a company whose assets consist principally of immovable property in Spain, with no exceptions for properties engaged in economic activities. Let us look at a scenario where a Luxembourg company makes a significant capital gain from transferring shares of a Spanish company whose main asset is a hotel. Would you say that the DTT allows Spain to tax this gain? In a recent judgment (December 27, Spanish version here), the Spanish High Court (*Audiencia Nacional*) does not.

The taxation of capital gains from the alienation of shares in real estate companies has recently drawn the attention of tax practitioners, due to article 9 of the Multilateral Instrument (which refers to the preceding natural year to assess whether the company should be characterized as a real estate company). However, in this case, the question is a classic one: how to assess whether the company's assets are mainly immovable property.

While the Commentaries on the OECD Model only refer to the comparison of the value between immovable properties and the value of all the property, there are two major positions on this issue: (i) assets should be valued based on their market value, an opinion held by several authors (e.g., in Spain, Joan Hortalà i Vallvé and Néstor Carmona Fernández), or (ii) assets should be valued based on their book value (opinion followed by Ekkehart Reimer for cases where the domestic law of the situs State does not provide special clauses).

The question becomes critical in the current case where the Spanish company presented a balance sheet showing total assets of €1.4 million, including €1 million corresponding to the hotel's net book value, while the global sale price the Luxembourg shareholder obtained was €23 million. On those grounds, the tax authorities argued that the company's assets were mainly immovable property in Spain, so the Luxembourg shareholder's gain would be taxable in Spain. However, the taxpayer alleged that the transaction did not involve an immovable property, but an ongoing business, stating that in addition to the hotel, the transferred company owns other assets (such as goodwill, contracts and market share) that should be relevant to its characterization as a real estate company, regardless of whether they are recorded in the books. Thus, the DTT should prevent Spain from taxing this capital gain under article 13.4 of the DTT (gains arising from the transfer of other assets).

Sharing the taxpayer's view, the judgment recognizes that it is not an indirect transfer of real estate, but a transfer of an ongoing business. It acknowledges that the Luxembourg company transferred shares in a company whose most significant asset was an immovable property (the hotel), but which also had other intangible assets (booked or not) required to carry on the activity. The difference between the book value and the market value of the shares proved, in the court's view, the relevance of the non-booked intangible assets. None of these other assets is characterized as immovable property for these purposes, so the court denies the taxation of the capital gain in Spain as the Spanish company's assets are not mainly immovable property in Spain.

The court also makes an interesting reference to a precedent in which the tax authorities accepted this argument when analyzing a special rule for the transfer of real estate companies in the field of indirect taxation, which aimed to tax indirect transfers of immovable properties by denying the application of general exemptions for the transfer of shares. The reasoning in that case, applied now for the purposes of the DTT in the field of direct taxation, emphasized the need for an interpretation of the rule according to its purpose, avoiding taxing the transfer of ongoing businesses that rely on immovable properties as a mere transfer of those properties. The reference to indirect taxes is also important because the Spanish Supreme Court (in other precedents that the High Court did not refer to in this judgement) also recognized for these purposes the relevance of non-booked goodwill when analyzing the characterization of a company as a real estate company.

To the extent that the Supreme Court will not review this case (we have been informally told that the tax authorities did not appeal), this judgment will be an important precedent for foreign investors in Spain to consider, as it raises a powerful argument against Spain's traditionally strict position on the taxation of Spanish-sourced real estate income. This argument should be available for all tax treaty investors (and not only for those resident in the EU), as it does not rely on Community Law.

The court's reasoning is well founded: you cannot rely on the historical book value of a real estate asset when applying a rule that aims to tax the market value of immovable properties. Although the judgment's text does not specifically mention updated appraisals of the property's value, we understand that the price paid for the shares was well over 50% of the market value of the building, including latent gains, as the standard practice is to value companies using dynamic methods based on EBITDA multiples and discounted cash flows.

Finally, note that the taxpayer raised an additional argument regarding a different treatment for EU taxpayers. Since the judgment prevents Spain from taxing the Luxembourg company's capital gain, according to the DTT, there is no specific analysis of this complaint and it is difficult to assess the terms alleged for such discrimination. However, this argument raises an interesting discussion on discrimination against EU taxpayers selling shares in Spanish real estate companies after 2015.

Since the Spanish tax reform in 2014, EU companies earning capital gains from transferring shares in Spanish subsidiaries qualify for the same participation exemption regime available for capital gains obtained by Spanish companies, with one exception: the transfer of subsidiaries whose main assets are directly or indirectly immovable properties in Spain. In these cases, a Spanish shareholder can apply an exemption to the capital gain (only a partial exemption corresponding to retained earnings if the subsidiary is a passive company), while an EU shareholder cannot apply an exemption (even though the assets are engaged in economic activities).

Therefore, in cases where the DTT allows Spain to tax these gains, discrimination occurs because

EU taxpayers pay taxes in cases where Spanish taxpayers do not. There is one precedent for the non-resident taxpayer: in 2013, the Supreme Court awarded a French corporate taxpayer identical relief for double taxation on capital gains as the relief allowed for Spanish companies (credit corresponding to retained earnings). Surely, the Spanish (maybe also European) courts will analyze this case in the short term.

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