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The Wider Spanish Tax Exemption on Interest through the Danish Filter

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The judgments of the European Court of Justice (ECJ) on the withholding tax exemption provided by the Interest and Royalties Directive (available here – the 'IRD judgment') and the Parent-Subsidiary Directive (available here – 'the PSD judgment') on February 26, 2019 ('the Danish cases') have raised many issues to discuss. As some authors have pointed out (see Luja's post, available here), an open question refers to the consequences of the judgments for the domestic legislation of the EU Member States when such legislation provides withholding tax exemptions before the EU Directives obliged them to do so. Are these EU Member States constrained by the interpretation of the ECJ?

This is the case of the Spanish withholding exemption on interest paid to EU lenders. While the Interest and Royalties Directive (IRD) was proposed in 1998 and enacted in 2003, Spain's domestic exemption was introduced in 1990 through two different pieces of legislation: Royal Decree-Law 5/1990 (for individual non-resident taxpayers) and Act 31/1990 (for corporate non-resident taxpayers). Although the first proposals of the Commission arose in 1990 (never examined by the ECOFIN and finally withdrawn, check here) and the coetaneous Act 18/1991 mentions that the exemption had to deal with the foreseen scenario of free movement of capital within the EU, no direct link with the IRD can be identified for obvious chronologic reasons.

The Spanish domestic withholding exemption on interest was drafted in broader terms than required 13 years later in the IRD. Three aspects can be highlighted: (i) unlike the IRD, it does not require the recipient to take a particular form or to be subject and not exempt to a particular tax; (ii) it applies to non-related EU lenders, while the IRD only provides exemption for interest paid to associated companies; (iii) remarkably, and contrary to the IRD, the wording of the exemption does not require the recipient of the interest to be its beneficial owner.

Because of this, Spain did not need to transpose the IRD. Only a minor amendment was introduced by Act 62/2003 to allow the application of the exemption in case permanent establishments of EU entities located in other EU Member States derived Spanish-sourced interest. However, even in the field of permanent establishments, the Spanish domestic exemption is wider: it applies to interest paid by any permanent establishment located in Spain, while under the IRD, both the permanent establishment and its home office must be located in the EU and the interest must be a tax-deductible expense for the permanent establishment.

The key question is whether the IRD judgment should affect the interpretation of a domestic withholding tax exemption on interest, which is in force before the IRD was enacted and is deliberately wider in its content. In our opinion, the answer can be found on the basis that two different concepts are interpreted by the ECJ in this judgment: beneficial ownership and tax abuse.

Several commentators have noted that both concepts are intertwined in the judgments (e.g., Schwarz's post, available here). In fact, the interplay between them is confusing in the IRD judgment (as it is in the PSD judgment, see our last post, available here). However, we agree with Møllin and Andersen (Derivatives & Financial Instruments, vol. 21, IBFD) that under EU law, the concept of beneficial ownership is not intended to address anti-avoidance. It is a concept that defines the scope of the IRD (article 1), which may be capable of dealing with certain cases of abuse even though this is not its nature. Thus, both concepts should be reviewed separately:

On the one hand, the ECJ interprets beneficial ownership in para. 84-94 because, under the IRD, the recipient of the interest should be its beneficial owner for the withholding exemption to apply. In the IRD judgment, the ECJ acknowledges that such a concept does not hinge on national legislation but has an EU meaning that derives from the concept of beneficial ownership included in the OECD model. It refers to an entity that actually benefits from it and has the power to determine its use freely. As a requirement established by the IRD, beneficial ownership in a third state leads to the denial of the benefits of the IRD and it has nothing to do with fraud or an abuse of rights (para. 138): proof that beneficial ownership is not an anti-avoidance rule?

On the other hand, the ECJ analyzes the concept of abuse in para. 95-onwards, stating that its application does not require a specific domestic or agreement-based provision because there is a general principle of EU law under which abusive practices are prohibited. There is no need for this principle to be transposed, the ECJ says (para. 105 of the IRD judgment). The Court also provides several indicators to ascertain when a particular transaction can be considered abusive because it is an artificial arrangement. These indicators are sometimes similar to the circumstances that one would consider when assessing whether the recipient is the beneficial owner of the income; for example, the fact that interest is passed on by the recipient very soon after it is received, or the fact that in substance the recipient does not have the right to use and enjoy the sums. However, the Court does not introduce the indicators as tools to analyze beneficial ownership but as relevant evidence to identify an artificial arrangement. In this sense, it can be understood why the ECJ refers several times to beneficial ownership when analyzing the burden of proof of abuse (para. 140-145).

Based on the existence of different categories (i.e. assuming beneficial ownership is a requirement established in article 1 of the IRD and the prohibition of abuse is a general principle of EU law), the question raised above can be split in two.

First question: can the Spanish tax authorities oblige the recipient of the interest to be its beneficial owner in order to apply the domestic withholding exemption? In our opinion, the answer is no, because Spanish legislation lacks this requirement – Spain is free to enact more liberal rules and grant benefits that go beyond a directive (as noted by the ECJ Task Force's Opinion Statement, available here) and even to decide whether or not to levy a tax (as Spain does with listed bonds) – and the beneficial ownership test is not a general principle of EU law that can apply even in the absence of transposition.

Otherwise, the outcome would be contrary to previous case law of the ECJ mentioned in the

Danish cases (judgment of July 5, 2007, Kofoed case, available here), where the Court noted that the principle of legal certainty precludes directives from being able to create obligations for taxpayers by themselves. In other words, if the Spanish legislature refused to include the beneficial ownership test, it cannot be read in Spanish legislation even if it is required in the IRD and the ECJ has interpreted it, because the IRD would be creating the obligation for the recipient to be the beneficial owner of the interest.

This interpretation is consistent with Spanish case law on the application of the domestic withholding exemption on interest. In its judgment dated October 31, 2017, the High Court confirmed that the domestic exemption lacks any beneficial ownership requirement, so that any challenge could be based on the proper application of the Spanish general anti-avoidance rules (GAAR) only (see our previous post, available here).[1] Other Spanish authors commenting on the Danish cases have the same opinion (Sanz Gadea, *Revista de Contabilidad y Tributación*, vol. 435, CEF).

This aspect leads us to the second question: is the IRD judgment irrelevant for the application of the Spanish GAAR regarding the interest withholding exemption? In our view, the answer is again no because of how the concept of abuse is developed by the ECJ in the Danish cases, which seems to be closely linked to the concept of abuse in the general anti-avoidance rule established in article 6 of the Anti-Avoidance Directive.

This European GAAR is a minimum level of protection that EU Member States must incorporate into their domestic legislation (article 3 of the Anti-Avoidance Directive), meaning Spain is obliged to have GAAR to be able to deny tax benefits to situations that would be considered fraudulent or abusive practices from an EU perspective. Therefore, the concept of abuse included in the Danish cases and the indicators of abuse developed by the ECJ could be relevant when considering whether abuse exists when applying the Spanish GAAR to the domestic withholding exemption on interest.

As previously discussed, the indicators provided by the ECJ recall some relevant criteria that would be considered when analyzing beneficial ownership. From this standpoint, one may argue that the beneficial ownership test is relevant for the application of the domestic withholding exemption. However, this would be the case only to the extent the concept of abuse is built up on aspects that can overlap with the analysis of beneficial ownership. As mentioned, under the Spanish domestic exemption beneficial ownership should never be analyzed as a separate category.

The above conclusion does not only have material implications, but also procedural consequences: in Spain, there is a special procedure for declaring tax abuse that the tax authorities should not circumvent by applying the concept of beneficial ownership directly, as the High Court prevented them to do in its judgment of October 31, 2017.

Finally, let us make a brief reference to Brexit as side note. When (or if) it takes place, the UK will no longer be considered an EU Member State, and the Spanish domestic exemption will no longer apply to UK lenders. As article 11 of the Spain-UK Double Tax Treaty provides a withholding exemption on interest, there should be no material consequences, apart from the fact that treaty entitlement would be needed and this article requires the recipient of the income to be its beneficial owner.

The inclusion of the beneficial ownership test will capture certain cases of abuse. However, from a

conceptual standpoint, within the Treaty, the avoidance analysis will refer to the PPT clause to be included through the MLI. Would the Danish cases affect the interpretation of the Treaty? Surprisingly (or not), the answer should be yes for those who think the PPT is the mandatory implementation of the EU GAAR into the double tax treaties of the Member States, as well as for those who argue that Spanish domestic GAAR (shaped by the EU concept of abuse) can apply to double tax treaties signed by Spain.

END NOTES

[1] This approach could be considered challenged by the judgment of the Spanish High Court dated November 30, 2018 (available here), where a beneficial ownership test is read in article 12 of the Spain-Switzerland Double Tax Treaty even though the article lacks any reference to it. The Court argues a dynamic interpretation of the Treaty (despite been amended twice, in 2007 and in 2013, after its signature in 1966), which will be reviewed by the Supreme Court.

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