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PRACTITIONERS' CORNER

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On November 8, 2012, the Spanish High Court (Audiencia Nacional, or AN) delivered its ruling on the application of the EU parent-subsidiary directive (2011/96/EU) to the distribution of dividends by a Spanish subsidiary to its U.K. parent, which was controlled by a non-EU resident.

The ruling is important. It consolidates the AN's position on the interpretation of the antiabuse provision contained in the Spanish implementation of the EU parent-subsidiary directive. The judgment clarifies the provision's scope in relation to the court's previous decisions of May 25, 2010, and May 31, 2012.

Parent-Subsidiary Directive

The EU parent-subsidiary directive provides for a 0 percent withholding tax on dividends paid between entities resident in EU member states under certain conditions. The EU directive, as implemented by Spain, includes an antiabuse provision that excludes the withholding tax exemption on distributions made to direct EU shareholders when most of the voting rights of the EU parent company are directly or indirectly owned by non-EU residents. However, in that case, the 0 percent dividend withholding tax would still apply if one of the following conditions (the so-called safe harbors) is satisfied:

- the EU parent entity is in fact conducting a business directly linked to the Spanish subsidiary's business;

- the business purpose of the parent entity is the management of the subsidiary with the necessary organization of human and material resources; or
- evidence can be given that the EU parent was incorporated for sound economic reasons and not solely to benefit from the withholding tax exemption.

The Facts

The factual background of the case was as follows. Mr. Cándido, an individual resident for tax purposes in Dubai, held a 100 percent participation in a U.K. holding company (UKCo). UKCo held a 100 percent participation in a Spanish company involved in Spanish real estate acquisition and development (SpanishCo).

UKCo had no employees and had its fiscal domicile in the office of a U.K. law firm; its single asset was the shares of SpanishCo. Cándido directly managed and controlled UKCo.

In 2002 SpanishCo distributed dividends to UKCo totaling €1.8 million, with a 0 percent withholding tax on application of the EU parent-subsidiary directive. In 2003 UKCo distributed dividends to Cándido totaling €1.4 million, based on its 2002 earnings.

The Spanish tax authorities denied the application of the 0 percent dividend withholding tax on the dividends paid by SpanishCo to UKCo, claiming that the antiabuse provision should apply. This was due to the

fact that most of the voting rights of UKCo were directly owned by an individual who was not resident in the EU (that is, who was resident in Dubai).

However, the tax authorities considered the Spain-U.K. tax treaty to be applicable; that treaty establishes that the dividends' taxation at source is limited to 10 percent. This was the withholding tax assessed by the Spanish tax authorities to SpanishCo, as withholding agent (together with penalties and interest).

SpanishCo opposed that assessment before the Spanish Central Economic-Administrative Court, but its claims were rejected. SpanishCo then appealed before the high court.

The AN's Decision

The AN confirmed the position of the Spanish tax authorities and economic administrative court, determining the nonapplication of 0 percent dividend withholding tax on the dividends paid by SpanishCo to UKCo. In particular, the AN noted that the facts of the case showed a clear and paradigmatic application of the antiabuse provision.

The most relevant aspect of the decision refers to the arguments AN used to reach such conclusion, which constitute interesting interpretative criteria for the application of the EU parent-subsidiary directive. Such doctrine can be summarized as follows:

- The main purpose of the antiabuse provision of the EU parent-subsidiary directive, as implemented by Spain, is to avoid the incorrect application of the 0 percent dividend withholding tax through the interposition of EU conduit companies in cases in which the ultimate parent is a non-EU resident.
- The Spanish antiabuse clause is structured in a way that is compatible with EU law, irrespective of its wide scope, because of the fact that the safe harbors in the rule allow taxpayers to prove the absence of reasons for its application.
- As regards the application of such safe harbors, the AN made several clarifications of great practical relevance, namely:
 - Burden of proof on the fulfillment of the requisites of the safe harbors falls on taxpayers.
 - Such burden of proof should not be required to the maximum rigor, in a way of demanding a "full or complete proof, but would be enough with a 'half-proof' (*semiplena probatio*)" of the existence and activity of the EU resident company is based on effective and valid

reasons. Thus, the courts should encourage the most favorable interpretation to permit any proof or evidence to avoid, even in a presumptive way, the existence of fraud.

- The evidence must be logically related to the terms expressed in the safe harbors established by the law:
 - that the EU holding company develops a business activity "within the fullest meaning that the term could allow";
 - that the EU parent entity is in fact conducting a business directly linked to the Spanish subsidiary's business;
 - that the business purpose of the parent entity is the management of the subsidiary; or
 - that the taxpayer's arguments provide a principle of proof on the business purpose of the existence of the EU parent, other than a purely tax-driven purpose of obtaining the 0 percent dividend withholding tax.

The AN applied this doctrine to the case, rejecting the application of safe harbors, as the taxpayer did not provide any evidence of its fulfillment. Rather, the court verified that:

- UKCo lacked economic substance (that is, employees and business assets);
- UKCo did not develop active economic functions;
- the economic purpose for the establishment of UKCo was not justified; and
- the beneficial owner of the dividends distributed by SpanishCo was the individual resident in Dubai.

Concluding Remarks

In our opinion, the AN decision should be appreciated for providing a set of criteria that allows a flexible and reasonable interpretation of the Spanish antiabuse provision, in light of its purpose and in connection with the EU parent-subsidiary directive.

The AN's insistence on the artificiality of the structure, together with the weighted use of the rules of burden of proof, place this pronouncement in a position that is aligned with the European Court of Justice's doctrine on antiabuse provisions.

However, it is unclear why the Spanish tax authorities allowed the application of the Spain-U.K. tax treaty to the case (that is, 10 percent withholding tax), as the facts of the case (lack of economic substance of UKCo, management and control of UKCo in a third state) could have led perfectly to the application of tax treaty antiabuse rules (beneficial ownership or other). ♦