ATOZ TAX ADVISERS

ATOZ ALERT

European Court of Justice rules on Spanish withholding tax on US RICs

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"Neutralisation" at shareholder level makes the WHT acceptable in theory, but subject to a very (impossibly?) high bar. The case is sent back to the Spanish Supreme court to assess could this bar ever be cleared in practice.

Today, the Court of Justice of the European Union ("**CJEU**") issued its decision (the "**Decision**") regarding reclaims of withholding tax ("**WHT**") filed on behalf of iShares Europe ETF (the "**Fund**"), a US regulated investment company ("**US RIC**"). The case, managed by the ATOZ and Taxand network, deals with questions raised on WHT applied on dividend distributions from Spanish resident entities to the Fund.

In particular, the Spanish Supreme Court asked the CJEU to clarify the following:

1. whether the mere availability of an option for the US RIC to claim the foreign tax credit or transfer it to its investors based on the Spain – United States ("**US**") Double Tax treaty ("**DTT**") was sufficient to neutralise the discriminatory effect of the Spanish WHT paid on dividends distributed from Spanish listed companies, and;
2. whether it remained necessary to examine whether neutralisation had in fact occurred at investor level when the US RIC chose to transfer the income and corresponding tax credit to its investors.

The questions on potential neutralisation of discriminatory WHT had previously been discussed by the Spanish Courts, with this unresolved discussion effectively blocking US investment funds from successfully claiming WHT.

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Background

In 2007, 2009 and 2010, the Fund received dividends from Spanish listed companies which were subject to a rate of 15% WHT, pursuant to the Spain–US DTT. In order to be considered a RIC and be taxed under the specific tax regime provided for in US law, a US resident investment fund must distribute at least 90% of their returns (excluding net capital gains)[1]. RICs have the right to deduct all dividends paid to their shareholders or unitholders from their taxable income[2].

This means that RICs are practically exempt from taxation in the US, since their special regulations allow most of the income they make up to be deducted as long as it is distributed to their investors. Subject to specific conditions, RICs may elect to pass through to their shareholders foreign taxes in the form of a tax credit (including Spanish WHT). For the period in question, the Fund satisfied both the conditions for qualification as a US RIC and to make the election to pass through the Spanish tax credit to its investors.

The Fund filed a refund request on the basis that the 15% Spanish WHT is discriminatory when compared with the treatment applicable to a Spanish collective investment undertaking in an objectively comparable position[3]. Under the Spanish tax regime, a Spanish collective investment undertaking would effectively have been subject to Spanish Corporation Tax at a rate of **1%**. The Fund therefore argued that the 14-percentage point difference constituted a restriction on the free movement of capital under Article 63 of the Treaty on the Functioning of the European Union ("**TFEU**").

The Spanish authorities rejected the claim, concluding that the Fund was not in an objectively comparable situation to a Spanish collective investment undertaking and that the collected WHT did not infringe EU law.

The Fund subsequently appealed to the Central Economic-Administrative Court. By decision of **5 October 2017**, that court dismissed the appeal. It upheld the view that the Fund was not objectively comparable to a Spanish collective investment undertaking and additionally held that the Fund had to establish that any restriction on the free movement of capital had not been neutralised through deduction of the Spanish withholding tax in the US. The Fund appealed the decision to the Spanish National Court.

In a judgment dated **12 September 2022**, the National Court upheld the Fund's appeal and recognised its right to a refund of the amounts claimed, together with default interest.

The National Court found that the Fund was objectively comparable to Spanish collective investment undertakings and that the Spanish tax rules were discriminatory because they imposed a higher WHT on non-resident collective investment undertakings without providing an equivalent mechanism for repayment. The court further held that the potential neutralisation of the disadvantage through US taxation could not be assessed by requiring the Fund to prove, at a secondary level, that its investors themselves had been unable to make full use of the relevant foreign tax credit. It also considered that the Fund's decision to pass the tax credit on to its investors did not, by itself, establish full and effective neutralisation, since the ability of individual investors to use the credit depended on their particular tax circumstances.

[1] Section 852(a)(1) of the US Internal Revenue Code

[2] Section 852(a) of the US Internal Revenue Code

[3] pursuant to Article 28(5)(b) of the consolidated text of the Law on corporation tax, approved by Royal Legislative Decree 4/2004, of 5 March, and in Law 35/2003, of 4 November, on Collective Investment Schemes

The Spanish authorities appealed the judgment to the Spanish Supreme Court. The appeal was admitted on 21 June 2023 and concerned, in essence, whether the discriminatory effect of the Spanish WHT could be regarded as neutralised where the non-resident investment undertaking had the option, under the applicable DTT and domestic law, either:

- to claim the foreign tax credit itself; or
- to pass the income and tax credit on to its investors.

The Supreme Court also sought clarification as to whether, where full neutralisation was available to the RIC at the first level, but the RIC chose to transfer the income and tax credit to its investors, it remained necessary to examine whether neutralisation actually occurred at investor level.

Following the above, the Supreme Court referred these issues to the CJEU for a preliminary ruling.

Analysis of the CJEU

Firstly, the Court analysed in general if a restriction of free movement of capital exists, finding that dividend payments to the Fund were subjected to less favourable treatment than the dividend payments to resident UCITS[4] and therefore a clear discrimination existed.
As a next step, the Court analysed if this discriminatory treatment could be "neutralised" based on the applicable DTT.

According to the CJEU, a restriction on the free movement of capital may be considered to be neutralised where a number of conditions are all met:

- the collective investment undertaking;
    - benefits, in its State of residence, from a tax transparency regime;
    - is not taxed on the dividends received; and
    - passes on to its investors the dividends and the tax credit corresponding to the WHT levied,
- the investors can effectively use this tax credit to fully and effectively deduct the amount corresponding to the difference in taxation between resident and non-resident collective investment undertakings.
- This neutralisation is granted by the terms of the DTT, not merely as a provision of internal law

Impact of the Decision and the way forward

This decision is significant for pending WHT reclaim claims in Spain.

It will be interesting to see how the Spanish Supreme Court will apply it in its subsequent decision. If the Spanish Supreme Court follows the Courts decision, it seems difficult or impossible for the tax authorities to prove that neutralisation at the level of the shareholders was effective in the case of US RICs. Firstly, any relief at shareholder level seems to be internal law based, rather than DTT based as the Court required. Secondly, proving full and effective credit is an impossible task for the Spanish Tax authorities in most, if not all, cases.

[4] Paragraph 31 of the Decision

Depending on the outcome, it should remove the final major obstacle to the granting of substantial refunds by the Spanish Tax Authorities and courts in both pending and future cases.

We await the Spanish Supreme Court's interpretation of the judgment and its decision in the pending proceedings with great interest.

Questions?

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