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ATOZ NEWS

Spanish Supreme Court Decisions on Dividend Withholding Tax Applied to US Mutual Funds

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Two groundbreaking decisions for non-EU funds were issued by the Spanish Supreme Court confirming that Spanish withholding tax levied on dividends paid by Spanish corporations to collective investment fund resident in the United States ("**US RICs**") was discriminatory and contrary to European law.

On 13 and 14 November 2019, the Spanish Supreme Court issued two judgements in regard to the right of a US RIC to receive a refund of the withholding tax paid on dividends received from Spanish companies. Following the positive decision issued for foreign UCITS funds earlier in the year, this Spanish Supreme Court judgment follows on with a positive decision for US RICs.

The key questions addressed in the appeals were similar to the ones that we have been litigating in the claims lead by the Taxand network, more specifically:

1. Whether the analysis of comparability between US RICs and collective investment funds resident in Spain ("**Spanish CIIs**") should be carried out in accordance with Spanish law or in accordance with the UCITS Directive;
2. Whether the withholding tax is a justified restriction on the free movement of capital under Article 64.1 of the Treaty of the Functioning of the European Union ("**TFEU**");
3. Whether the existing mechanism for exchange of information ("**EOI**") contained within the tax treaty between the Kingdom of Spain and the US ("**Tax Treaty**") could have been sufficient or clearly insufficient in the tax year 2009.

In its decisions, the Spanish Supreme Court concluded that in relation to US RICs:

- comparability is measured by reference to the UCITS Directive and not to the Spanish Law regulating CIIs;
- imposing a higher tax rate on funds from third countries (i.e. US RICs) that have proven to be comparable to Spanish CIIs is an unjustified restriction of the free movement of capital (Article 63 of the TFEU); and

- that the EOI mechanism established in the Tax Treaty is sufficient for the Spanish Tax Authorities to carry out the appropriate checks/validations they may need to perform, so that lack of verifiable information cannot be used to justify a restriction on the free movement of capital.

Further to the above, the Spanish Supreme Court concluded that if the taxpayer has made a substantial effort to evidence its comparability - which is yet to be determined - the burden of proof is shifted to the Spanish Tax Authorities to perform the analysis and obtain any validations it requires through the EOI.

Therefore, if the Spanish Tax Authorities have done very little to discredit the evidence provided by the fund (other than denying the refund based on the provisions in force), the fund has the right to a refund of the unduly paid withholding tax.

According to the Court, the Spanish special corporate tax scheme, which gives rise to a lower taxation for Spanish CIIs, is discriminatory in so far as it discriminates based on residence. Even if a non-EU fund would prove compliance with all the same requirements as the Spanish CIIs (especially with regard to the minimum capital and number of participants), the non-EU funds would not be able to benefit from the special corporate tax scheme, since it is reserved only for Spanish funds.

In other words, the sole mechanism by which a breach of Article 63 TFEU could be disproven would be in the case where national law would allow for a mechanism for non-EU funds to access the special corporate tax scheme subject to the non-EU fund demonstrating compliance with the UCITS Directive. However, no such mechanism was provided under Spanish domestic law.

In both decisions the Spanish Supreme Court refers to the Emerging Markets judgement (C-190/12) issued by the CJEU, in which it specifies that the fact a non-EU fund does not fall within the scope of the UCITS Directive does not in and of itself mean that the non-EU fund is not comparable to a UCITS fund as a non-EU fund, based on its residence alone, would never be within the scope of the UCITS Directive. The importance and emphasis is put on non-EU funds being similar or equivalent and not identical as otherwise it deprives the principle of freedom of movement of capital of any effectiveness.

The Spanish Supreme Court further ruled that the EOI contained within the Tax Treaty was sufficient to obtain any verification the Spanish Tax Authorities or Courts would require in order to ensure that the funds operate within a legislative framework equivalent to that of the European Union. Furthermore, the EOI requires that all means have been exhausted internally prior to applying the EOI. In the case at hand, the Spanish Tax Authorities had received information requested from the fund and the fund had provided the information it deemed appropriate to respond to the queries raised by the Spanish Tax Authorities. Furthermore, the CJEU has upheld that the Tax Authorities can request any proof they deem necessary to assess whether the conditions required are met in order to benefit from a preferential regime. However, the non-resident may not be subjected to an excessive administrative burden that would essentially prevent it from benefiting from a preferential regime.

The Spanish Supreme Court stated that due to the claimant having provided extensive evidence in order to establish its comparability, as well as the Spanish Tax Authorities not exhausting their means of verification via the Tax Treaty, the case was awarded to the claimant.

Considering that over the last years, cases before the Spanish Courts as well as the Spanish Tax Authorities have been substantially supported with extensive evidence from the Internal Revenue Services ("**IRS**"), the Securities Exchange Commission ("**SEC**") as well as other fund documentation that would have been verifiable via the EOI, we expect that this ruling will have a positive impact on all the US RIC claims before the court – subject to the cases having been supported with the appropriate proof to ensure they can be deemed comparable to UCITS (not Spanish CIIs).

It will need to be seen how the Spanish National Court will apply the Spanish Supreme Court's decisions to the cases it has pending. Nevertheless, the National Court has already requested claimants to explain how the Spanish Supreme Court decisions are applicable to their case at hand.

We are pleased to see though that the Spanish Supreme Court has upheld the application of Article 63 TFEU with regards to its application to non-EU funds, as has been supported by various CJEU decisions in the past and has refuted the Spanish Tax Authorities' attempts to severely restrain the application of Article 63 by attempting to interpret the meaning of comparability as requiring non-EU funds to be identical to Spanish CIIs. Furthermore, the burden of proof that had been laid at the door of the claimants in order to prove comparability was significant due to the Spanish Tax Authorities not using a verification tool at its disposal – the EOI.

We look forward to seeing how the Spanish National Court will apply the Spanish Supreme Court's rulings to those pending cases so as to have a better understanding of the extent that the burden of proof and which elements determine comparability in practice from a Spanish perspective. However, considering the fact that the comparability analysis should be performed to UCITS and not Spanish CIIs, we expect that the burden of proof will be eased.

One element that remains to be seen in future decisions ruled by the National Court, or other courts, is to what extent this ruling will impact the exchange traded funds as well as the 81-100 and §584 trusts. We expect to receive further insight into this during 2020, so watch this space.

Can we help? Do you have further questions?

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