GARRIGUES

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The primacy of EU law over Spanish law no longer appears to raise any doubts and there are numerous judgments from Spanish courts which, based on this principle, set aside administrative decisions which, although in keeping with Spanish law, infringe EU law.

A good example of this can be seen in the recent judgments by the Madrid High Court on November 19, 2013 in which the Court disapplied the Nonresident Income Tax Law in order to afford the same tax treatment to a taxpayer residing in Sweden as that which would have applied to a taxpayer residing in Spain. Specifically, these judgments granted the right to a refund of the tax withheld on the dividends obtained in Spain by a foundation that was tax resident in Sweden, affording it the same tax treatment as that applicable to comparable Spanish foundations. The judgments also recognized the right to late-payment interest, which began to accrue when the withholding tax was paid over to the public treasury.

The Court held categorically that both situations are comparable on the ground that comparability does not require the circumstances between the resident and nonresident taxpayers to be absolutely identical. The key factor is whether the resident and the nonresident find themselves in an objectively comparable situation. In addition, the Court held that late-payment interest starts to accrue as soon as the tax infringing EU law is paid over to the public treasury, as in the case of claims for refunds of tax that has been paid incorrectly.

The importance of these judgments goes beyond nonresident foundations, as there are two important issues that can be extrapolated to many other nonresident taxpayers in cases where EU law is infringed, who are claiming refunds of taxes withheld on dividends obtained in Spain: first of all, the issue of late-payment interest and, second, the issue of the sufficiency of the withholding tax certificates produced as evidence.

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1. JUDGMENTS

1.1 Nonresident income tax.- Nonresident foundations do not have to pay withholding tax on their dividends, just as resident foundations do not have to (Madrid High Court. Three judgments of November 19, 2013)

As previewed in the introduction to this Newsletter, the Madrid High Court has just recognized that a Swedish foundation (which, moreover, was not established in Spain) has the right to a refund of the withholding tax that it paid on a distribution of dividends from Spain, based on the principle of primacy of EU law and following an in-depth analysis of the requirement of comparability (between nonresident and resident foundations).

It is also worth noting that the judgments also acknowledged that the withholding tax certificates produced by the taxpayer in the proceeding constituted sufficient evidence of the payment of the dividends and the consequent tax withheld in Spain. In this respect, the Court held that, in any case, even if there were an error in form 296, 'annual summary of withholding tax on cash payments and on payments in kind for nonresidents' (a circumstance which was not proven in the proceeding), it would be the result of the conduct of the maker of the return rather than that of the taxpayer.

1.2 Personal income tax.- The deadline established by a Ministerial Order for electing to apply the inbound expatriates regime is not an essential requirement (National Appellate Court. Judgment of July 11, 2013)

The appellant elected to apply the special regime for workers posted from abroad after the two-month deadline imposed by the Ministerial Order that implemented such election had passed. The election had been made before the Ministry of Finance published the Ministerial Order, which established the procedure for making the election, which included the above-mentioned deadline.

Both the Cataluña Regional Economic-Administrative Tribunal (TEAR) and the Central Economic-Administrative Tribunal (TEAC) ruled that the late filing of the form and documentation after the two-month deadline set in the Ministerial Order had to result in forfeiture of the statutory right to make the election, on the ground that the deadline was an essential requirement for the exercise of the right. Taking a different view, the National Appellate Court held that going beyond the relevance that could be attributed to a time limit imposed in a Ministerial Order, the taxpayer had made the election after the entry into force of a provision having statutory force and had complied with the substantive requirements imposed in that provision.

The Court also noted that the interpretation used by the TEAR and TEAC in their decisions was overly formalistic in that it constituted a clear denial of the appellant's due process rights. Therefore, the Court rejected the argument that a deadline set in a Ministerial Order could constitute an essential requirement for the exercise of a right where the statutory provision that regulated such right did not make its exercise conditional on any time limit whatsoever; and all the more so in this specific case, given that the taxpayer had made the election to apply the special regime in the only way possible at that time (before the making of the Order that approved the form for making the election) and had properly fulfilled the request for rectification received subsequently by filing the official form in question.

1.3 Inheritance and gift tax.- An inheritance tax provision that leads to different treatment depending on whether or not the deceased person and heir reside in a given State is contrary to the free movement of capital (Court of Justice of the European Union. Judgment of October 17, 2013 in case C-181/12)

The request for a preliminary ruling referred to a married couple who resided in Switzerland (a non-EU country) where the husband was the universal heir of his deceased wife who had assets (a building and balances in bank accounts) in Germany. Specifically, the widower argued that the free movement of capital was infringed because the German law on inheritance tax established a reduction of up to €500,000 where the heir or the deceased person resided in Germany, whereas the reduction was limited to €2,000 where they did not.

The Court of Justice of the European Union (CJEU) concluded that the German law was contrary to the free movement of capital given that the difference in treatment established by reason of residence had to concern situations which were not comparable or justifiable by overriding reasons in the public interest, something which was not the case in the question referred for the preliminary ruling.

The line of reasoning of this judgment could be used in the current debate existing in Spain regarding inheritance and gift tax legislation, and specifically regarding the possible unconstitutionality of the inheritance and gift tax reduction established by the Valencia Autonomous Community Government, since this reduction is conditional on the taxpayer residing in the Valencia autonomous community.

1.4 Inheritance and gift tax.- The appraisal of a property for transfer tax purposes cannot be used for inheritance tax purposes (National Appellate Court. Judgment of September 26, 2013)

The appellants asked the Court to set aside the assessments issued for inheritance and gift tax on nonresidents on the ground that the assessments revised upwards the value that the appellants had allocated to certain hotel rooms that they had inherited.

The appellants contended that the value reported was based on an appraisal by the Canary Islands tax authorities for transfer and stamp tax purposes when a room in the same hotel and with the same characteristics was transferred.

The National Appellate Court began by engaging in a painstaking analysis of the burden of proof, concluding that the appellants had not provided any proof to rebut the appraisal by the tax authorities and had shown passivity by not requesting their own appraisal from an independent expert.

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In addition, with respect to the difference in the appraisal standards used by the various authorities, the National Appellate Court considered that the principles of the compartmentalization of taxes and of unity or uniqueness do not prevail in the Spanish tax system in an absolute manner, and concluded that each case must be analyzed by having regard to the differences that exist between the taxes in question when ascertaining whether or not one appraisal for all taxes is possible. Lastly, the Court considered that in the case at hand the appraisal by the autonomous community government could not be a fetter on the tax authorities' power to inspect for the purposes of inheritance and gift tax, since different taxes and authorities are involved and they are dealing with prerequisites that do not necessarily coincide.

1.5 Inheritance and gift tax.- 99% reduction by reason of kinship: the tax becomes chargeable when the gift is accepted by the beneficiary in a public deed (Madrid High Court. Judgment of May 28, 2013)

In this case, the tax authorities had issued a provisional assessment in which they disallowed the 99% tax reduction by reason of kinship in a gift between a father and daughter, on the grounds that the tax had become chargeable on the date on which the bank transfer was made, and that on that date none of the requirements imposed by the legislation to qualify for the reduction were met: (i) formalization in a public document; and (ii) identification of the origin of the funds in the public deed where cash gifts were involved.

However, the Madrid High Court took a different view, holding that:

a) In accordance with the provisions regulating gifts in the Civil Code, it could not be construed that the date on which the tax became chargeable was the date of the bank transfer, given that the transfer could take place without the beneficiary's prior or simultaneous knowledge.

b) The tax was deemed to have become chargeable upon execution of the public deed of acceptance by the beneficiary (even if it occurred after the bank transfer), since there was no record of the beneficiary's knowledge or acceptance of the payment of the gift until that date.

1.6 Inspection proceeding.- In enforcing a decision under the General Taxation Law (1963), late-payment interest is calculated up to the time when the partially set-aside original assessment is issued (National Appellate Court. Judgment of July 17, 2013)

In the case analyzed a fresh assessment was issued pursuant to a decision rendered by the TEAC ordering the proceedings to be rolled back in time because the administrative appeal against the original assessment had been partially upheld. This new assessment was appealed against at the National Appellate Court.

First of all, the appellant argued that the deadline for rendering a decision in the inspection proceeding had passed and that the proceeding had been stayed for longer than six months. The National Appellate Court rejected this argument because, in its opinion, steps taken to enforce a court decision or an economic-administrative claim under the 1963 General Taxation Law ("LGT") could not be considered to be inspection proceedings in the proper sense of the word and, therefore, were not subject to those time limits.

The appellant also argued that the late-payment interest had been miscalculated according to the Supreme Court's recent interpretation in its judgments of June 14, October 25, and November 19, 2012, namely, that in the event of an assessment being partially upheld, late-payment interest would accrue until the date on which the original assessment being set aside was issued, since any delay after that date should be attributable to the tax authorities.

The Court followed the interpretation adopted by the Supreme Court and accepted that the above interpretation was valid in cases where the 1963 LGT applied as it was silent in this connection, unlike the current LGT, which does expressly regulate this matter (in articles 26 and 240).

2. DECISIONS AND RULINGS

2.1 Corporate income tax.– Tax treatment of the Dubai Free Zone (Directorate-General of Taxes. Ruling V2797-13 of September 20, 2013)

This ruling examined whether the Spain-United Arab Emirates ("UAE") tax treaty was applicable to a subsidiary setting up for business in the Dubai Free Zone and considered the tax treatment of dividends repatriated from that subsidiary to Spain.

The Directorate-General of Taxes ("DGT") began by recalling that free zones were areas within the territory of a given country where that country's competent authorities authorized the pursuit of industrial, commercial or service activities, while qualifying for certain tax reliefs by virtue of the fact that such activities were not deemed to be carried on within that country's customs territory.

Therefore even though, for customs purposes, free zones were not treated as the territory of the country in question, they nevertheless formed part of that territory, meaning that in principle the tax treaty would not cease to apply for that reason. In the specific case of the UAE:

a) The tax treaty provided that companies formed in the UAE would be treated as companies resident in the UAE if they had their place of effective management there.

b) Therefore, since the tax treaty applied throughout the territory of the UAE and free zones formed part of that territory, the activities carried on in those free zones by companies resident in the UAE would be covered by the provisions of the tax treaty.

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As for the possibility of claiming the exemption in article 21 of the revised Corporate Income Tax Law (the "TRLIS") for the dividends distributed by the subsidiary, the DGT pointed out that since the tax treaty applied to the subsidiary and it contained an exchange-of-information provision, the requirement that it be subject to a tax of a nature identical or analogous to Spanish corporate income tax had to be deemed fulfilled.

2.2 Corporate income tax.– Tax treatment of amounts received for a purchase option (Directorate-General of Taxes. Ruling V2794-13 of September 20, 2013)

The entity requesting the ruling leased out a warehouse with a purchase option in favor of the tenant, separately invoicing on a monthly basis the amount relating to the rent and the amount of the purchase option. The latter amount would be subtracted from the transfer price if the tenant exercised the purchase option. The transaction was recognized by the requesting entity as an operating lease since it was not certain that the tenant would exercise the purchase option.

The requesting entity asked whether the amounts received in respect of the purchase option had to be treated as revenues for the year in which they were received or, on the other hand, as customer advances that should be taken to income when the purchase option was exercised. Assuming that the lease had been correctly recognized as an operating lease, the DGT ruled that:

a) When the invoices were collected, as regards the part relating to the purchase option, an item of revenue for rent should be recognized and would be computable for tax purposes.

b) Subsequently, when the tenant exercised the purchase option, the requesting entity should derecognize the net carrying amount of the leased warehouse, with a debit to cash (at the sale price less the amount paid for the purchase option), and recognize, in respect of the difference, a gain or loss in the income statement, which would have tax effects.

2.3 Corporate income tax.– A reasoned report will not be binding for the purpose of quantifying the R&D&I tax credit base (Directorate-General of Taxes. Ruling V2698-13 of September 10, 2013)

Article 35 TRLIS regulates the tax credit for research, development and technological innovation (R&D&I) activities. Subarticle 4 provides that taxpayers may submit a report from the Ministry of Science and Technology (now the Ministry of Economy and Competitiveness), or from an agency attached to the Ministry, on compliance with the scientific and technological requirements to classify the taxpayer's activities as R&D or technological innovation activities. Such report will be binding on the tax authorities.

The DGT clarified that under no circumstances would the quantification of the tax credit base contained in the reasoned report be binding on the tax authorities, since it was not the specific purpose of the reasoned report.

The DGT also recalled that the tax credit base in the case of R&D activities would comprise direct expenses accrued in the year and duly specified in each project, meaning that the base could not include in any case general or indirect expenses (in respect of the portion attributable to the R&D project).

2.4 Special SOCIMI tax regime.– Various issues clarified. Rulings V2759-13 and V2760-13, both of September 19, 2013)

The regime governing listed corporations for investment in the real estate market (SOCIMIs), established in Law 11/2009, of October 26, 2009, was modified in depth with effect for fiscal years beginning on or after January 1, 2013.

In the wake of the modification of the regime, numerous issues arose, some of which have been resolved by rulings V2759-13 and V2760-13. We should recall, very briefly and simply, that the regime permits SOCIMIs (listed or unlisted) to be taxed at 0% if the dividends distributed to shareholders with an interest representing at least 5% of the capital stock are taxed at a minimum rate of 10%.

In relation to the rulings, the following is worth noting:

a) First of all, it can be seen that the DGT interpreted the <u>requirement on which assets were admitted assets for the application of the special regime</u> flexibly.

   Article 2.4 of the Law provides that the real estate must be owned by the SOCIMI, treating it solely for these purposes as if it were the title resulting from surface, air or accessory building rights. Both rulings confirmed that real estate leased out under administrative concessions and under agreements providing for rights and obligations similar to those under an instrument of title or surface right would have the status of an investment admitted for such purposes.

b) In relation to the <u>requirement to keep the real estate leased out for three years</u>:

   - The Law provides that a breach of this requirement does not mean the forfeiture of the regime, but it does mean taxation pursuant to the general regime and at the general tax rate in the case of the income generated by the real estate during the application of the special regime.

   - The DGT stated that the following would be taxed at the general rate:

     - The income per books derived from each real estate asset, to be determined for each real estate asset transferred before the above period. This income would comprise the gross revenue derived from its operation, less expenses directly related to the obtainment of the revenue, and less the general expenses corresponding proportionally to the revenue.

     - Any gain on the transfer of the real estate asset would be calculated pursuant to accounting rules.

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c) Moreover, the rulings have resolved doubts relating to the unlisted SOCIMIs envisaged in article 2.1.c) of Law 11/2009, and to the nonresident companies provided for in article 2.1.b) as the parent entities of unlisted SOCIMIs. In particular, one of the doubts concerned the moment in time when such entities had to meet the requirements to apply the special regime, i.e., whether the requirements had to be met before the election to apply the regime or during the subsequent two-year transitional period provided for in the Law. The DGT stated that the following requirements had to be met always before the election was made:

- The nonresident entities had to have (i) the same corporate purpose as the SOCIMI (acquisition and development of urban real estate for leasehold purposes), (ii) a regime similar to that governing the SOCIMI in terms of the mandatory legal or bylaw policy of distributing dividends, and (iii) registered shares. For these purposes, the DGT clarified that the last-mentioned requirement would be deemed to be met if the nonresident entity were capable of ensuring the identifiability of shareholders representing at least 95% of its capital stock at the time of making the election.

- In turn, unlisted SOCIMIs had to meet the above requirements relating to the registered nature of their shares and the dividend distribution policy; moreover (i) their corporate purpose had to be the acquisition and development of urban real estate for leasehold purposes (meaning that, at the date of the election, the resident entity could not have holdings in other entities), and (ii) they had to be wholly and directly owned by one or more SOCIMIs or nonresident entities of the kind referred to above.

  The DGT clarified that such entities did not need to have the legal form of a corporation (*sociedad anónima*), and would not be subject to the minimum capital stock and corporate name requirements in article 5 of the Law.

d) The DGT also clarified the entry and exit rules.

In particular, the Law provides that tax adjustments pending reversal when entering the regime must be taxed pursuant to the general regime and at the general tax rate, when those adjustments are reversed. The doubt was whether the entry and exit rules would also apply to the reversal of accounting impairment losses which were provisioned before entering the regime and were tax deductible (in other words, losses that did not give rise to nonaccounting tax adjustments).

The DGT clarified that the reversal of these deductible accounting impairment losses would be taxed at 0%. In other words, it was made clear that when the Law was referring to taxation pursuant to the general regime and at the general tax rate when entering the special regime, it was only doing so in relation to nonaccounting tax adjustments.

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e) Lastly, note that the DGT also made clear that income taxed at the general rate (including income resulting from a breach of the requirement to keep the real estate leased out) would be offset by any tax loss carryforwards incurred before the first tax period in which the SOCIMI regime was applicable. Any unused tax credits pre-dating that period could also be taken, subject to the statutory limits on the tax charge.

2.5 Administrative proceeding.- Filing documents at foreign post offices is valid if the filing date, the identity of the document and the body to which it is addressed are guaranteed (Central Economic-Administrative Tribunal. Decision of July 18, 2013)

In the case at hand, the tax authorities took the view that an appeal for reconsideration filed at a Czech post office by a non-established trader had been filed out of time. In particular, the trader had sent the appeal by registered mail within the statutory time period for doing so, although it was received by the Spanish tax authorities after that period had expired.

Faced with this situation, the TEAC followed the line previously taken by the Supreme Court in this connection as well as similar judgments handed down by the National Appellate Court, and upheld the appeal, ruling that it had to be deemed that the appeal had been filed in time because, even though Spanish legislation specified that only the filing of documents at offices belonging to Sociedad Estatal Correos y Telégrafos, S.A. would be valid, the aims sought to be guaranteed by that legislation could reasonably be considered to have been achieved, namely, the filing date, the identity of the documents filed, and the body to which they were addressed. Such guarantees were met in this case as there was evidence that the appeal had been filed on a date before the end of the stipulated time period for doing so.

3. MISCELLANEOUS

3.1 Financial reporting framework where the application of the going concern principle is not appropriate. ICAC decision

The decision of the Spanish Accounting and Audit Institute (ICAC) dated October 18, 2013 was published in the Official State Gazette on October 25, 2013. The decision lays down the criteria for preparing financial statements where it is not appropriate to apply the going concern principle.

Thus, in terms of scope, the decision seeks to establish the necessary reporting framework when the going concern principle does not apply, in order to comply with the obligation to prepare financial statements in legal situations of liquidation or immediately before resolving to dissolve the company, where those responsible for preparing the financial statements, albeit after year-end, decide that they wish to liquidate the company or cease operations, or where there is no more realistic alternative to doing so.

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The decision divides into six rules, which analyze their objective and scope of application, the specific criteria for applying the Conceptual Framework for Accounting, the rules on recognition and measurement, and the rules on preparation and formulation of financial statements, all in relation to enterprises “in liquidation” and, finally, the new application of the going concern principle.

3.2 Court fees: ruling on unconstitutionality of reforms

In a judgment dated September 6, 2013, the National Appellate Court considered a request for a ruling on the unconstitutionality of two amendments made to the system of court fees in the February 2013 reform (specifically, to articles 7.1 and .2 and 8.2 of Law 10/2012 regulating Certain Fees in the context of the Justice System and of the National Institute of Toxicology and Forensic Sciences, as amended by Royal Decree 3/2013).

First of all, the Court held that the obligation of prior payment of the fee on pain of preclusion from the procedural step and, therefore, the termination of the proceeding was unconstitutional, since it violated the right to an effective remedy before the courts. Even though the Court pointed out that requiring a fee within certain limits and proceedings was perfectly constitutional, it was not possible for the payment of the fee to condition (i) the possibility of access to the jurisdiction; or (ii) the possibility of obtaining judicial protection. These were two consequences (unavoidable if the fees were not paid) that could be construed as unconstitutional.

The Court went on to say that the amendments failed to take into account proportionality and that the end pursued by the reform was to drastically reduce the litigiousness that had to be faced by the Spanish judicial system by only permitting legal entities and individuals with sufficient financial means to have access to justice. According to the Court, this circumstance was demonstrated by the fact that the number of appeals filed since the entry into force of the changes had fallen.

Second, the Court examined the unconstitutionality of the articles setting new amounts for fees in the judicial review jurisdiction and held that they contravened the fundamental right to formal equality before the law, consistent with the right to substantive equality. Thus, the Court pointed out that the vast majority of the population, who did not fall within the legal cases qualifying for free legal aid, often had to spend a disproportionate amount of money compared to the amount claimed, and that this showed that the manifest aim of the increased fees was deterrence. All of this made it necessary for the Court to find the new provisions unconstitutional.

3.3 Retail sales of certain hydrocarbons: request for preliminary ruling and opinion of the Advocate General

A request for a preliminary ruling to the CJEU was made by the Cataluña High Court in relation to the national tax on retail sales of certain hydrocarbons (Case C-82/12), the origin of which can be traced to an appeal filed by a Spanish entity applying for a refund of the tax paid between 2005 and 2008, on the ground that the tax was contrary to Directive 92/12/EC on products subject to excise taxes.

In his opinion, the Advocate General corroborated the company's stance, stating that in his view the tax was contrary to EU law because it did not meet the requirements that the Directive imposed for other taxes on such products, namely: (i) it did not serve a specific non-budgetary purpose (but rather was a general revenue-raising exercise), and (ii) it did not respect the rules on determination of the tax base, calculation or chargeability of excise taxes or VAT.

In relation to the purpose of the tax, the Advocate General argued that, without prejudice to the possibility of it being argued that there was a *predetermined* purpose—health and/or environmental—in reality in the instant case, the purpose of the tax was merely budgetary, because the structure of the tax was not the result of the achievement of that purpose and the use of the revenue from that tax to achieve such purpose was so general that a mere revenue-raising purpose was evidenced.

As for the failure to comply with the rules for determining the excise tax base or the VAT taxable amount, the Advocate General took the view that the tax was contrary to EU law because it was not levied at all stages of the production process like VAT and became chargeable at a different moment in time to that of excise taxes.

Lastly, the Advocate General considered that the effects of the judgment should not be time-limited in the event that it were held that the tax was contrary to EU law, given that the Kingdom of Spain had not acted in good faith because the Commission had stated at every available opportunity that, in its opinion, the tax was contrary to EU law.

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