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THE SPANISH SUPREME COURT CONFIRMS THAT NON-SPANISH SOVEREIGN WEALTH FUNDS MAY BE FULLY EXEMPT FROM TAX ON SPANISH SOURCE DIVIDENDS (AND ANY OTHER SPANISH SOURCE INCOME)

Non-Spanish sovereign wealth funds should be exempt from tax on Spanish source income provided that they are objectively comparable to a Spanish sovereign wealth fund, such as the Spanish Social Security Reserve Fund, the goals of which include funding Spain’s public pension liabilities.

1. INTRODUCTION

In a previous Newsletter[1] we addressed a significant ruling from the Spanish Supreme Court issued on 22 December 2020, which ruled against the difference in tax treatment between Spanish and non-Spanish resident pension funds as regards dividends paid by Spanish resident companies in specific cases. While Spanish resident pension funds (and certain pension funds resident in the European Union or the European Economic Area) were not subject to tax on Spanish source dividends, other non-Spanish resident pension funds were subject to non-refundable withholding tax.

The Spanish Supreme Court has now handed down a significant ruling, issued on 24 February 2021 (the “**Ruling**”), which also **prohibits differences in tax treatment between Spanish resident sovereign wealth funds and non-Spanish resident sovereign wealth funds**. The Ruling confirms the tendency of the Spanish Supreme Court to endorse equal tax-treatment rights on the basis of the EU principle of free movement of capital for those non-Spanish resident entities that are in an “*objectively comparable*” situation to Spanish resident entities entitled to domestic tax benefits, such as an exemption from tax or a reduced Corporate Income Tax rate.

2. THE RULING

The **Spanish Social Security Reserve Fund is a governmental fund which is fully exempt from Spanish Corporate Income Tax** on its worldwide income. Formed in 2000, it is a sovereign fund the main purpose of which is to meet the future needs of the Spanish social security system in terms of contributory benefits (retirement, illness, etc.).

[1] Click here to see the Newsletter.

On the contrary, **non-Spanish sovereign wealth funds are fully subject to a 19% Spanish-source dividend withholding tax**, unless the relevant tax treaty states otherwise. Such funds are taxable at the standard 19% or 24% tax rate on other Spanish source income.

On the basis of this inequality (i.e. discrimination) in the taxation of dividends, back in 2010 (!) the Norwegian Government Pension Fund Global (one of the world's largest sovereign funds), which is managed by Norges Bank, the Norwegian Central Bank, submitted a request to the Spanish tax authorities seeking a refund of the withholding tax charged on Spanish source dividends, which was denied. This decision by the Spanish tax authorities was overturned by the Spanish High Court (*Audiencia Nacional*) and, after a subsequent appeal, by the Spanish Supreme Court, on the basis that the Spanish tax rules were not in compliance with the **EU principle of free movement of capital**.

According to the Spanish Supreme Court, sovereign wealth funds are subject to the same regulations as other market players – including tax rules and EU law – when they act as investors in the capital markets. In this regard, **non-Spanish resident sovereign funds**, regardless of whether they are resident or not in the European Union or the European Economic Area ("**EEA**"), **will be exempt from tax on Spanish source dividends** provided that (i) they are in an "*objectively comparable*" situation to an exempt Spanish sovereign wealth fund, and (ii) that there is no general public-interest reason – other than the obtaining of tax revenue – that would justify the difference in tax treatment.

It is significant that the High Court ruling undertook an in-depth analysis of the nature, functions and form of management of the Government Pension Fund Global in order to verify that, as the fund claimed, it was objectively comparable to the Spanish Social Security Reserve Fund and, therefore, was entitled to the same tax treatment.

We must highlight that the Spanish Supreme Court confirmed this view as the Government Pension Fund Global **included as one of its goals the Norwegian State's long-term savings for the purpose of covering future pension liabilities**. However, a significant reference was made by the High Court to the ECJ ruling in case C-485/14, which dealt with an exemption from French gift tax that benefited, among others, public agencies and the State of France, as well as those agencies of the EU and the EEA, but which did not apply to other states and their agencies. The ECJ concluded that such discrimination was contrary to the principle of free movement of capital. This ruling is extremely significant as, under the Spanish CIT rules, the Spanish State and its agencies are exempt from tax and so, one could conclude, other sovereign states and their public agencies should likewise be exempt.

3. CONCLUSIONS

The Ruling is extremely significant because of its scope and far-reaching consequences, which go beyond the taxation of dividends earned by sovereign wealth funds. The following conclusions must be made:

(i) The **exemption will apply to any sovereign wealth fund** that can evidence **that it is in the same situation as the Spanish Social Security Reserve Fund** and that it shares the same nature and characteristics as the latter. This conclusion does not require that the relevant sovereign wealth fund be "identical" to the Spanish Social Security Reserve Fund, but that it should be "*objectively comparable*".

(ii) The exemption will apply as long as the relevant sovereign wealth fund has as **one of its purposes the funding of future pension liabilities**.

(iii) Given that the Spanish Social Security Reserve Fund is exempt from Corporate Income Tax regardless of the type of income it earns, **the tax exemption will apply** not only to dividends but **to any Spanish source income** that is earned by the relevant sovereign wealth fund (such as interest or capital gains).

(iv) Furthermore, it is the view of the authors that, following the ECJ ruling in case C-485/14, cited in the High Court ruling, an exemption should apply if the Spanish source income is earned by a non-Spanish sovereign state, including its public agencies.

(v) The Ruling is based on the existence of an infringement of the EU principle of free movement of capital. As a consequence, **the conclusion of the Ruling does not automatically apply to a sovereign wealth fund investment when the EU principle of freedom of establishment applies**. As it refers to the holding of shares and the dividend income earned, such would be the case when, on the basis of the factual pattern of the investment made in the Spanish company, one can conclude that the sovereign wealth fund can exert “a definite influence” on the Spanish company’s decisions, as this concept has been defined by the EU Court of Justice, and which must be analysed in depth on a case-by-case basis.

(vi) Non-Spanish resident sovereign wealth funds that meet the abovementioned requirements can **request a refund of the Spanish withholding tax** from the Spanish tax authorities, at least for taxes paid within the four-year statute of limitations period.

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