

Spanish Tax Alert

Enbridge case: lack of “substance” of Danish holding company leads to denial of 0% dividend withholding tax under the EU Parent-Subsidiary Directive

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I. Introduction.

The Spanish National Appellate Court (the “**Court**”) has recently given a judgment¹ denying the application of the 0% dividend withholding tax under the European Union (“**EU**”) Parent-Subsidiary Directive (the “**Directive**”) on the distribution of dividends by a Spanish subsidiary to its Danish parent entity (ultimately controlled by a Canadian company: Enbridge).

The Directive, as transposed by Spain, provides for a 0% withholding tax on dividends paid between entities resident in EU/EEA Member States under certain conditions, but includes an anti-avoidance provision that excludes the withholding tax exemption on distributions made to direct EU shareholders when the majority of the voting rights of the EU parent company are directly or indirectly owned by individuals or legal persons that are not EU residents, unless the incorporation and operations of the EU parent company have a business purpose and substance.

This judgement confirms the position of the Spanish courts² in denying the entitlement to tax advantages based on a strict interpretation of the “substance” requirements provided in the anti-abuse provisions contained not only in Spanish domestic legislation, but also in the Spanish tax treaties in force.

In this case, even though in the end the taxpayer is allowed to apply the exemption due to procedural reasons, to determine the application or not of the anti-avoidance clause, the Court follows a restrictive interpretation of the business purpose and substance requirements that must be met by the EU parent company, when this company is controlled, directly or indirectly, by a ‘third-country’ (non-EU) resident company.

Hence, this is an important pronouncement that should be taken into account in order to determine whether the current international structures to invest in Spain through a holding company pass the business purpose and substance tests from a Spanish point of view or not.

¹ 3 June 2015 Case 264/2012.

² Over the last years, the Spanish courts have adopted the restricted approach developed by the tax administration as regards the lack of substance in artificial structures in the interpretation of domestic exemption and tax treaties. In this regard, the main judicial precedents have been the following: the National Appellate Court judgements of 25 May 2010 and 31 May 2012 and the Supreme Court judgments of 21 March 2012 and 4 April 2012.

II. The Facts

The factual background of the case was the following:

- From 2003 to 2005, a Spanish company (CLH) paid dividends to its Danish parent company Enbridge Capital APS ("**DanishCo**") - which held 25% of its share capital -, applying a 15% dividend withholding tax ("**WHT**")³. The shares of the Danish company were ultimately held by a Canadian company ("**Enbridge INC**" or the "**Canadian parent company**").
- Pursuant to the Directive, DanishCo requested from the Spanish Tax Authorities a full refund of the WHT applied in Spain by CLH in its dividend payments.
- The Spanish tax administration denied the full refund to DanishCo, contending that the Directive's anti-avoidance provisions should apply; bringing to bear, therefore, article 10 of the Tax Treaty between Spain and Denmark, which provides for a 15% WHT .
- According to the Spanish tax administration, the exemption could not be applied as DanishCo did not prove: (i) the existence of sufficient business substance in Denmark, and (ii) that its incorporation had a business purpose other than to unfairly benefit from the Directive's 0% dividend WHT exemption by its Canadian ultimate parent company.
- The aforementioned conclusions of the tax authorities were confirmed by the Spanish tax tribunal ("**TEAC**"), which ruled in favour of the tax authority's position.

III. The Court's decision

The Court confirmed the criteria of the Spanish Tax authorities and the TEAC, denying the application of the Directive's 0% WHT to dividends paid by CLH to DanishCo. In particular, the court concluded that the beneficial owner of the dividends was the Canadian parent company because of DanishCo's lack of business substance / purpose for its incorporation.

The most relevant aspect of the decision refers to the arguments used by the Court to reach such conclusion, which constitute interesting interpretative criteria to assess the business substance and purpose-related strength of international structures for the application of Spanish domestic / treaty tax advantages:

- DanishCo did not have any assets (i.e. material resources such as computers, printers, office furniture, etc.) to carry out its business. In addition, the registered office of DanishCo was rented out to a third-party supplier engaged in providing management and professional services to other companies.
- Despite DanishCo having had two employees (human resources) to manage its Spanish subsidiary, the Court concluded this could not be enough as, in the years reviewed, there was only one employee who was seconded to Spain, and the cost of his salary was borne by the Canadian parent company.
- DanishCo has not carried out any business in Denmark. The taxpayer contended that besides its activity of managing its Spanish subsidiary, DanishCo was also engaged in seeking and spotting potential investments in Europe. However, according to the Court, these activities were not sufficiently supported by the documentation provided by the taxpayer (lack of correspondence, transactions and other supporting documentation).
- The business purpose for the incorporation of DanishCo was not proven.

IV. The authors' comments

The main lesson to be learned from this case is the raising of thresholds to determine business purpose and substance in international structures. In this regard, qualitative substance on the part of a non-resident company is now specially required, implying a business logic and functional structures supported by substantial human and material resources.

The access to the WTH exemptions or tax advantages is thus conditioned by proof that the

³ 15% withholding tax rate applicable according to Spanish domestic law ("**NRITL**").

foreign holding company recipient has a business purpose other than to benefit from withholding tax exemptions. This would mean examining two main aspects concerning the holding company, namely:

- The business purpose underpinning its existence and its participation in the flow of income paid within the group. To this end, it would be crucial to substantiate the actual set of functions carried out by the holding company, as well as its relevance in the framework of the operation.
- The existence of actual substance in terms of human and material resources at the level of the holding company so as to adequately manage the activities and functions assigned to it. This could potentially be compatible with the possibility that certain tasks (especially routine tasks) could be outsourced to third-party suppliers.

The specific functions to be assigned to the holding company should be duly identified on

the basis of the Groups' needs and in a manner consistent with the business model of the Group and its Transfer Pricing policies.

The Spanish tax authorities (whose criterion has in most cases been confirmed by the Spanish Courts, as in the case under review) have in the past taken a very restrictive approach and denied not only the Directive's 0% dividend WHT, but also the treaty advantages when the facts and circumstances of the case pointed to the existence of a sham structure or a purely tax-driven scheme. In addition, under the Base Erosion Profit Shifting ("**BEPS**") framework, the restrictive interpretation given by the Spanish tax authorities has also been shared by the OECD⁴.

Therefore, we strongly recommend revisiting international structures (specially those involving holding companies), in order to review their compliance with the aforementioned criteria, since it seems insufficient that the holding entities have a basic "substance pack" to avoid a potential characterization as an abusive scheme by the Spanish tax authorities.

⁴ In this regard, BEPS Action 6 provides "Develop model treaty provisions and recommendations regarding the design of domestic rules to prevent the granting of treaty benefits in inappropriate circumstances".