

NEW SPANISH TAX TREATMENT ON SPANISH DIVIDENDS RECEIVED BY NON-SPANISH HEDGE FUNDS

The Spanish Supreme Court has confirmed, in five **Decisions** issued on 5 April 2023, 11 April 2023 and 25 April 2023 which have just been made public (the "**2023 Decisions**"), the application of a 1% withholding tax rate, instead of the general 19% withholding tax rate (or any applicable tax treaty reduced rate) to dividends obtained by non-Spanish hedge funds, similar to the approach adopted for EU funds under the scope of the UCITs Directive and non-EU funds comparable to UCITs.

EXECUTIVE SUMMARY

- Non-Spanish funds obtaining dividends from Spanish participated entities have normally been subject to the ordinary rate of tax (19%) or a reduced rate under a tax treaty (if available to them) while Spanish funds including hedge funds were taxed at 1% on the same kind of income.
- The above introduced a debate on whether **that could constitute discrimination** which was contrary to the freedom of establishment principles of the EU Treaties and Directives which had to be resolved by the courts.
- In recent years, **the Spanish courts have ruled that any difference in the tax treatment applicable to Spanish funds versus non-Spanish funds which could be considered comparable was discriminatory** and, hence, that non-Spanish funds should apply the same tax treatment subject to a favourable comparability analysis.
- Now, the 2023 Decisions state that French and German Alternative Investment Funds **should be able to apply the same tax treatment as a Spanish hedge fund subject to a comparability analysis**. Therefore, based on the 2023 Decisions, the same conclusion would apply to Alternative Investment Funds of any other EU State.
- The comparability analysis does not require that the foreign entity has identical features to that a Spanish fund but, simply, that it meets certain requirements considered essential such as having an open-ended nature (i.e., addressed to the public, without prejudice to having restrictions to professional or institutional investors), be authorized by the financial regulator of its country and be managed by an authorised manager.

Key issues

The decisions from the Spanish Supreme Court **apply to EU hedge funds**, although the approach **might be extended in the future to (i) non-EU hedge funds** and/or (ii) different sources of income (e.g., interest, capital gains).

- In the decisions, the Supreme Court establishes the **main comparability requirements** for non-Spanish hedge funds in order **to apply the 1% withholding tax rate** instead of the general 19% withholding tax rate (or any applicable tax treaty reduced rate).
- There are three main requirements to meet the comparability test: (i) **having an open-ended nature** (i.e., being addressed to the public without prejudice to restriction to professional or institutional investors); (ii) **being authorized by a financial regulator**; and (iii) **being managed by an authorized manager**. Other features may be considered for the comparability analysis.
- An important future milestone to be observed is whether the criteria of the 2023 Decisions are extended to (i) non-EU alternative investment/hedge funds and/or (ii) different sources of income.

BACKGROUND

Traditionally, Spanish investment funds are taxed for Spanish CIT purposes at a reduced 1% rate while non-Spanish funds investing in Spain and obtaining dividends from Spanish entities have normally been subject to the ordinary rate of tax (19%) or a reduced rate under a tax treaty. In recent years, several tax lawsuits were brought by different investment funds in order to achieve their right to be taxed in the same manner as Spanish funds.

In summary:

- At a first stage, **EU funds under the scope of the UCITs Directive** claimed that they should be treated identically. Their position was accepted, and the Tax Law was changed to recognise it.
- Later, **non-EU funds with features that could be considered similar to those covered by the UCITs Directive** also claimed their right to be treated in the same way from a tax point of view and, hence, be able to apply the reduced rate of 1% on any dividends obtained from Spanish participated entities. Again, the Spanish Supreme Court acknowledged that the tax treatment given by the Spanish Tax Authorities was discriminatory and allowed them to benefit from the reduced rate provided that they are able to support that they were entities comparable to UCITs Funds.
- Finally, hedge funds which were outside of the UCITs sphere also considered that they were suffering discriminatory treatment in Spain insofar as there were certain investment institutions that, despite not being harmonised and, hence, outside the UCITs umbrella, also enjoyed preferential tax treatment. This is the case of Spanish hedge funds (*fondos de inversión libre*) contemplated in the Spanish Law on Collective Investment Undertakings, although they do not have an EU regulation of reference (as is the case with UCITs Funds). To that end, several appeals were filed with different courts.

Thus, hedge funds based in France and Germany that invested directly in Spanish entities filed those claims. As regards the claim made by German hedge funds, in 2021 the Spanish National Court confirmed the application of the 1% reduced tax rate provided they were alternative investment funds in accordance with German regulations (this conclusion has been confirmed by the Spanish Supreme Court). On the contrary, the Madrid High Court rejected the application of the 1% reduced tax rate in relation to a French alternative investment fund.

Both cases were brought before the Spanish Supreme Court, which had to decide on the following aspects:

- The **basis for the comparability assessment** (whether the Spanish regulation or that of the fund's country of residence).
- The **specific parameters** (authorisation regime, number of unitholders, minimum share capital, open-ended nature... etc.), **that a non-resident hedge fund must meet** in order to demonstrate that the comparability analysis with a Spanish hedge fund is successful – and therefore, that it can apply the same tax regime as the latter.

The 2023 Decisions

The Supreme Court has adopted the **2023 Decisions**, which have just been made public and deal with the claims made by the French and German hedge funds.

The **Supreme Court has confirmed the discriminatory treatment suffered by French and German Alternative Investment Funds** and their right to benefit from the same tax treatment as Spanish hedge funds. According to the 2023 Decisions, the main requirements established by the Spanish Supreme Court for hedge funds **to meet the comparability analysis and apply the 1% reduced tax rate** on income for Spanish investments are as follows:

- i. The non-resident hedge funds **must be open-ended funds**, i.e. with a diversified portfolio that is available for repurchase and subscription continuously (it being possible to target professional or qualified investors).
- ii. The non-resident hedge funds must **have an authorisation issued by the financial regulator** equivalent to the Spanish Securities Market Commission to operate in their country of residence.
- iii. The non-resident hedge funds must certify that they are **managed by an authorised Alternative Investment Fund Manager** in accordance with the terms of Directive 2011/61/EU.

The Supreme Court also refers to other criteria such as the minimum capital, the number of investors, the diversification policy, although it does not consider them essential for the purposes of the above assessment for the comparability analysis.

Also, in line with the decisions issued in relation to non-EU funds comparable to UCITs, the 2023 Decisions make it clear that the comparability assessment does not require that the non-Spanish fund prove it is an entity identical to a Spanish hedge fund nor are the entities required to provide information that is not available, or is very difficult to obtain, in their country of residence.

Finally, a future important milestone to be observed is whether the criteria of the 2023 Decisions are extended to (i) **non-EU alternative investment/hedge funds** (as has occurred in recent years regarding pension funds and UCITs funds) and/or (ii) different sources of income (e.g., interest, capital gains).

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