Sovereign Wealth Funds can claim back withholdings on dividends from their investments in Spain

Eduardo Martínez-Matosas Ruiz de Alda
Partner, Tax Practice Area, Gómez-Acebo & Pombo

Luis Cuesta Cuesta
Senior Associate, Tax Practice Area, Gómez-Acebo & Pombo

Pilar Álvarez Barbeito
Associate Professor, Financial and Tax Law, Universidad de La Coruña.
Academic Counsel, Gómez-Acebo & Pombo

The Supreme Court confirms on appeal that subjecting Spanish-source dividends obtained by foreign SWFs to withholding tax is a violation of the principle of non-discrimination in the free movement of capital.

The Spanish Supreme Court, in its judgments of 24 February 2021 (appeal no. 3829/2019) and 2 March 2021 (appeal no. 3834/2019), resolves two appeals lodged against two judgments of the *Audiencia Nacional* in which Norges Bank (Central Bank of Norway) was granted the right to obtain a refund of Spanish dividend withholdings tax from their investments in Spain, with the appropriate late payment interest.

In the first of those judgments, the arguments whereof the second largely refers to, the *Audiencia Nacional* held that to subject to withholding tax - from 15% to 18% - dividends generated following the purchase of shares listed on the Spanish market by Norges Bank - as owner and manager of a collective investment scheme (Government Pension Fund Global) intended to cover future pension commitments in Norway, whereas the Spanish State or the Spanish Social Security are exempt when they obtain dividends of the same nature - under the provisions of Article 9 of the Corporate Income Tax (Recast) Act, the wording of which was similar to that of the current Article 9 of Act 27/2014 - entails a breach of the principle of non-discrimination in the free movement of capital.

In the appeal, the State Attorney (central government litigation lawyer) contends, first, that the principle could not have been infringed, since it is not applicable to entities that perform functions inherent in the exercise of public powers. According to this view, the activity of sovereign wealth funds (SWFs) investing in financial assets is not an economic activity for the purposes of the Treaty on the Functioning of the European Union (TFEU), in so far as it involves the exercise of public powers, a manifestation of State sovereignty. This argument has not been accepted by the Supreme Court, which takes the view that - regardless of both the heterogeneity of SWFs and the fact that they can be identified with the State that owns them - what is really decisive is that they are investors in the capital market in direct competition with private players, which neutralises the sovereign element as a relevant criterion for delimiting their activity and considering that public powers are being exercised through this activity. Understanding, therefore, that SWFs are financial investment vehicles subject to Union regulation that affects all investors in capital markets, the Supreme Court has no doubt that they are directly affected by the principle of free movement of capital, without any distinction being made in this context between foreign and national investors, without prejudice to the cases provided for in the Treaty that derogate from the general regime.

Precisely with a view to establishing the existence of such cases, the State Attorney argued, in the event that the above-mentioned principle were to apply, that the situations are not objectively comparable since, while the Norwegian SWF deserves such a classification - competing in the market as a private investor - the Social Security Reserve Fund does not have the characteristics of a SWF - as it is considered a public fund that invests only in securities issued by public persons, is financed by workers' contributions and whose sole purpose is to meet the future needs of the pension system. Once again, the Supreme Court disagrees with this argument, taking the view that the SWF nature of the Social Security Reserve Fund - deduced from the analysis of its structural and operational characteristics - makes it necessary to redirect the question to the analysis of whether, given that the principle of free movement of capital is applicable, the different treatment received by one fund and the other does constitutes arbitrary discrimination or a disguised restriction without sufficient justification.

It is the opinion of the State Attorney that there is no such discrimination, since the exemption at issue is justified because the envisaged bodies constitute integral parts of the same State that collects the taxes to finance the public services provided by those bodies, which operate in Spain on a non-profit-making basis, unlike Norges Bank. However, taking as a starting point the nature of SWFs as profit-making investment vehicles competing on the financial market for profit-making purposes - which can also be applied to the Social Security Reserve Fund - the Supreme Court believes that the aforementioned arguments, far from justifying non-discrimination, only further deepen discriminatory treatment that cannot be covered by an exemption provided by law for public bodies that are part of the State.

On the other hand, the State Attorney also claims that there are overriding reasons of public interest, linked essentially to the distribution of the taxing powers of States and to the coherence

of the tax system, to justify the different tax treatment. Thus, it highlights the fact that corporate income tax is a non-earmarked tax, intended to defray State expenditure, so that it makes no sense for the State to tax itself, also highlighting the fact that the tax is not applicable to the Norwegian State - so that there is no identity of situations between the Spanish and Norwegian States. The Supreme Court, for its part, understands that the appellant's own claims regarding the general and non-earmarked collection characteristics of corporate income tax are precisely those that exclude any reason of public interest that could justify the different tax treatment granted to the specific SWFs in question. In that sense, the revenue earned by SWFs on the financial markets has a clear lucrative purpose, pursuing a specific governmental aim and governed by legal and management rules clearly different from those that may be predicated of public revenue of a collecting nature.

In short, the different tax treatment of dividends obtained in the Spanish financial markets by the owner of the Social Security Reserve Fund and by the owner of the Norwegian SWF cannot be based on the existence of overriding reasons of public interest reliant on an alleged infringement of taxation powers, nor on the coherence of the tax system, and it must therefore be concluded that the only reason for the inequality and discrimination is purely of an economic and tax collection nature.

In accordance with the above arguments, the Supreme Court concludes that the taxation, without exemption from non-resident income tax, of Spanish-source dividends received by a non-resident public entity with no permanent establishment in Spain, which manages a collective investment scheme intended to cover future pension commitments in that other country, is contrary to the freedom of movement of capital, since the same income would be exempt from taxation if it had been received by the Social Security managerial bodies and centralised services.

As we have already pointed out, many of the arguments put forward in the aforementioned judgment have been reproduced in the Supreme Court judgment of 2 April 2021, which questioned the withholding tax to which, in that case, Spanish-source dividends obtained by Norges Bank, which, as owner and person responsible for managing that country's foreign currency reserve, invested part of it in shares of listed Spanish companies, had been subject. In that case, the claimant argued at the *Audiencia Nacional* that Norges Bank is an entity perfectly identifiable and comparable with the Bank of Spain, since both are endowed with similar functions, so that the non-application of the exemption from non-resident income tax to Spanish-source income earned by the Reserve owned by the Norwegian Central Bank amounted to discrimination incompatible with the provisions of direct and imperative application.

The *Audiencia Nacional* allowed the appeal on the basis of an essential factual premise: Norges Bank and the Bank of Spain are entities that perform “identical” functions for the purposes at hand, to the extent that “the profits of the Bank of Spain are mainly due to interest income on its main assets and gains from financial transactions (mainly due to capital gains on currency sales and foreign securities)” and “these profits are paid, in full, to the Treasury”. It adds, "The

Bank of Spain holds and manages the foreign exchange and precious metal reserves not transferred to the European Central Bank on similar terms to Norges Bank and is exempt from paying corporate income tax in Spain".

Well, the Supreme Court now affirms these arguments, understanding, therefore - in accordance with EU legislation and the case law of the Court of Justice of the European Union - that the Norwegian entity was discriminated against, leading it to reject the appeal lodged by the National Administration against the judgment of the *Audiencia Nacional*.

This case law therefore substantially alters the taxation of foreign SWFs earning income in Spain.