International Fiscal Transparency (IFT): the Spanish-Controlled Foreign Companies Tax Regime[1]

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1. Rationale and Nature of International Fiscal Transparency (IFT)

The term used in Spain to refer to the legal regime for Controlled Foreign Companies (CFC) is International Fiscal Transparency (hereafter, IFT, referring to the Spanish law on CFC), by which the Spanish legislator emphasizes "the tax effects arising from its application" instead of "the circumstances that give rise to the implementation of that regime" as the denomination of Controlled Foreign Companies does.[3]

The IFT regime responds to the need to ensure, in a context of economic globalization, the principle of taxation of worldwide income. This principle is not respected when taxpayers exercise the freedom of capital movement, primarily for fiscal reasons, locating in countries (or territories, such as Gibraltar) with a privileged tax regime, thus avoiding the inclusion of the income generated by that capital in their tax bases. This would go against the "ability-to-pay principle" as the core for sustaining public expenditure laid down in Article 31 of the Spanish Constitution.

The lack of adequate harmonization as well as clear collaboration between States in the field of direct taxation, both inside and outside the EU, leads States to adopt domestic measures in order to face the situation. As a result, we encounter anti-avoidance provisions in national legal systems, which may pose problems at the international level, especially when the States have concluded a double taxation convention (DTC), and at the EU

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[3] ALMUDÍ CID, J.M., "El régimen antielusivo de Transparencia Fiscal Internacional", in *Fiscalidad Internacional*, Monografías Ed. CEF. 3rd ed., 2007, p. 995.

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law level. Mention should also be made of possible friction with the constitutional principles of tax justice.

Although the Spanish regulation of IFT is intended to strengthen the principle of worldwide income taxation by resident shareholders, this objective cannot be pursued to the point of totally ignoring the principle of independent taxation of non-resident companies, since they possess a distinct legal personality from their shareholders.

The Capital Export Neutrality (CEN) principle is also related to this underlying rationale of the IFT regime. This principle implies that income obtained by a resident company, directly or through subsidiaries, should bear the same taxation. This could easily be avoided if there were no IFT rules. However, the Spanish regulation of IFT does not reach the point of imposing the CEN principle on all types of income: it is limited to so-called "passive income" or "front company income." By the same token, Capital Import Neutrality (CIN) only applies to income derived from genuine business activities.

As a result, it appears that "International Fiscal Transparency is the meeting point between the principles of neutrality in both import and export of capital, but also between the principles of worldwide income and independent taxation of legal entities. The peaceful coexistence among the mentioned principles is based, ultimately, on a value judgment regarding the kind of income".[4]

In this regard, three kinds of income obtained by CFC should be distinguished: a) income from passive investments that is not derived from actual business activities (passive income, such as dividends, interests, or royalties when they have no business nature); b) income derived from a genuine business activity (active business income), and c) the so-called *base company income*, which is intended to erode the tax base of resident shareholders.

From a theoretical perspective it is possible to distinguish between different CFC regimes depending on which income is subject to taxation in the tax base of resident shareholders. Whereas the "transactional approach" refers

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[4] SANZ GADEA, E., *Medidas antielusión fiscal.* Documentos del IEF. Núm. 8/09, p. 111.

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to a CFC regulation where only some of this income (known as "tainted income") is taxed, the "all or nothing approach" taxes all or none of this income, depending on the place of residence of the CFC, the taxation applicable, and the degree of establishment of the non-resident company in its place of residence.

This approach, also known as "entity approach", usually combines with the "jurisdictional approach" that focuses on the location of the non-resident entity.[5] As a result, the difference between these approaches is clear, as the OEDC points out: "under a pure transactional approach, all tainted income of the CFC would be attributed to domestic shareholders regardless of the resident jurisdiction of the CFC. The location of the CFC is irrelevant. Under a pure jurisdictional approach, all income of a CFC in a designated target territory would be attributed to domestic shareholders. The nature of the income earned by the CFC is irrelevant".[6]

However, Spanish IFT does not fit into this sharp theoretical separation between approaches. Although the application of IFT rules depends on criteria proper to the "jurisdictional approach" leading to an allegedly "entity approach", when applied, the IFT does not target all forms of income, but adopts a "transactional approach" identifying the income that would be attributed to shareholders residing in Spain.

Legal scholars have outlined three different legal foundations to justify CFC taxation:[7]

- The "deemed dividend approach" implies that CFC earnings should be considered dividends and consequently taxable income obtained by shareholders, i.e. the taxpayer. Since Spanish IFT levies taxes only on certain forms of income earned by the foreign entity, this doctrinal justification cannot be used.
- The "piercing of the veil approach" amounts to an income allocation system. In this approach, the income is deemed to have been allocated to the shareholders. This means disregarding, for tax purposes, the company's

[5] *OECD, Controlled Foreign Company Legislation, 1996*, at p. 99.
[6] *OECD, Controlled Foreign Company Legislation. 1996*, at p. 46.
[7] See *OECD, International Tax Avoidance and Evasion, 1987, at p. 66; and Controlled Foreign Company Legislation, 1996, at p. 20.*

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legal personality *vis-à-vis* the shareholders. However, even this theory cannot explain Spanish IFT regulation, because, once again, not every form of income is subject to taxation. In addition Spanish IFT excludes cases in which the non-resident company has been taxed at a similar rate (at least 75% of the Spanish Corporation Tax).

- The "increased ability to pay approach" is the third option. Participation in a non-resident entity can be seen as an increase in the ability to pay of the shareholders, which should result immediately in it being considered as a taxable event. This approach suits Spanish IFT the best.

International Fiscal Transparency was introduced into Spanish law by Act 42/1994, on fiscal, administrative and social measures entering into force on 1 January 1995, applicable to both natural and legal persons (Articles 2 and 10). Currently, this legal regime is foreseen in different norms. Act 35/2006 on Personal Income Tax (henceforth, LIRPF) regulates this matter regarding resident individuals (Article 91) ("Imputation of income in the international fiscal transparency regime"), while resident companies are governed by Royal Legislative Decree 4/2004, approving the Consolidated Text of the Corporate Tax Act (hereafter, TRLIS), (Article 107), entitled "Inclusion in the tax base of certain income derived by non-resident entities", under Chapter XI on "International Fiscal Transparency".

The Preamble of Act 42/1994 made clear the practical reason why IFT was introduced in Spain, that is "to avoid the deferral in the payment of taxes by non-resident companies subject to lower taxation" and "to prevent the reduction of the tax base in Spain through the billing of expenses to those non-resident companies".

Summing up, "the main objective of IFT is to offset or eliminate the advantages for Spanish residents and entities of using international instruments by interposing entities in foreign territories with low or zero taxation, for the sole purpose of avoiding or deferring payment of Spanish income taxes".[8] However, it will be argued that the IFT system can also be

[8] RODRÍGUEZ ONDARZA, J.A y RUBIO GUERRERO, J.J. «La transparencia fiscal internacional: protocolos para su aplicación», in *Revista Crónica Tributaria,* núm.96, 2000, at p. 123.

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applied to companies carrying out genuine business activities, if they have a significant percentage of purely instrumental assets without repatriating their profits. As a result, this IFT measure also encourages the repatriation of profits, which could be characterized as a restriction on EU fundamental freedoms.

2. Requirements for the implementation of IFT

The Spanish IFT regime requires three conditions to be met. The lack of one of these conditions results in the non-application of IFT.

The first one is the level of participation in the non-resident company or the control over the non-resident company.

The second one is the tax regime of the non-resident company.

The third one is the type of income earned by the non-resident company.

2.1. *Control over the non-resident company*

The application of IFT requires taxpayers (either individuals subject to Spanish Personal Income Tax (IRPF), or legal entities subject to Corporate Income Tax (IS)), alone or with related parties, to hold a direct or indirect participation of 50% or more in the capital, equity, results (profits) or voting rights of the non-resident company (Articles 91.1 a) LIRPF and 107.1 a) TRLIS). This percentage should be held by this entity at the end of the fiscal year. As a result, it is easy to circumvent this regime by transferring the shares prior to this date (though it should be borne in mind that this transfer would generate a capital gain that would be taxable under the general tax regime).

In setting this percentage, the Spanish legislation was intended to target only those shareholders who have effective control over the entity. This complies with the "ability to pay principle", because it seeks to avoid minority shareholders paying for dividends that they may well never receive, as they cannot decide on the distribution of dividends.[9]

[9] See ALMUDÍ CID, J.M., supra n. 1, at pp. 1008, 1013; and RODRÍGUEZ-PONGA SALAMANCA, E., "Trasparencia fiscal internacional", *Impuestos*, núm. 2. 1995, at p. 177.

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The adoption of the different criteria mentioned above is aimed at dealing with all the different types of control of the non-resident company in accordance with the law of the country where the company resides. As a result, it is sufficient for this percentage to be reached in relation to any of these criteria. There is no priority among them and no regard is taken of any anomalies. For example, IFT applies when the shareholder enjoys economic participation but no voting rights and vice versa.

This rule might suggest, in principle, that minority shareholders are completely excluded, but it should be borne in mind that the rules for calculating the percentage include direct and indirect[10] participation, so that they might end up fulfilling this requirement.

For instance, with regard to Personal Income Tax, this percentage can be reached individually, or in combination with other resident related individuals[11] (spouse and/or relatives up to the second degree by consanguinity or affinity) or related parties, i.e., entities under their control (Article 16 TRLIS).

In the case of Corporate Income Tax (IS), this percentage of participation can also be determined individually or jointly with other related natural persons (either resident or non-resident),[12] and related entities foreseen in Article 16 TRLIS.

This disparity concerning the assessment of control can give rise to incongruent results. In fact, IFT would apply to a natural person together with their relatives and a related resident entity (in cases in which 50% of control reached), but it would *not* apply to the resident related entity itself, because not all the relatives would be taken into account.

In addition, the criterion of control as regulated by Spanish IFT can easily be avoided by grouping "unrelated" persons or entities.[13]

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[10] Indirect participation is only considered in the case of related non-resident entities.

[11] RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 178.

[12] These related persons are shareholders, board members and administrators of an entity (or any entity belonging to the same group) and their spouses and relatives to the third degree by consanguinity or affinity (Article 16.3, points a), b), c) and g) TRLIS. These persons' participation must amount to either 5% or 1% in stock market securities. See RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 179.

[13] SANZ GADEA, E., *Transparencia fiscal internacional.* Documentos IEF núm. 18/02, at p.12.

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Finally it should be borne in mind that the burden of proof of this control falls on the Tax Authorities, and there is no presumption reversing this burden of proof.[14]

2.2. *The taxation of non-resident companies: identifying a privileged tax regime*

IFT also requires the tax paid by the non-resident entity, due for a tax identical or similar to Spanish Corporate Income Tax, to be less than 75% of the amount that would result from applying Spanish Corporate Income Tax to the income that must be included in the tax base of the resident taxpayer (Article 91.1 b) LIRPF and Article 107.1 b) TRLIS).

The Spanish legislator therefore sets at 75% the threshold for determining when a country (or territory) enjoys privileged taxation, but this criterion is applied in a somewhat blindfolded way, since it disregards whether the overall level of taxation in the foreign country is equivalent to Spanish taxation or not. This lower taxation may be based not on a privileged tax regime, but merely by applying different rules concerning Corporation Income Tax, such as different approaches to fiscal depreciation or deductions.[15]

Alongside this comparative method for determining low tax territories, Spanish legislation provides a "grey list" in Royal Decree 1080/1991.[16] This "grey list" includes the countries and territories that can be considered as tax havens. This list includes, at present, certain EU Member States (Cyprus, Malta and Luxembourg for certain types of income)[17] and territories such as Gibraltar.

When the non-resident company resides in any of these territories, IFT (Articles 91.11 LIRPF and 107.12 TRLIS) establishes three rebuttable

[14] RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 177.

[15] RODRIGUEZ-PONGA SALAMANCA, E., supra n. 7, at. pp. 190-193, 219; SANFRUTOS GAMBIN, E., "La transparencia fiscal internacional (TFI) en el IRPF", *Crónica Tributaria*, núm.89/1999, at p. 140.

[16] This list, updated on 1 February 2003, may be subject to change, since the Royal Decree provides that it is not possible to consider as a tax haven any country with which a DTC or a tax mutual assistance agreement has been concluded.

[17] Despite the fact that Luxembourg and Malta have agreed to a DTC and obviously any relevant European directive on mutual assistance applies.

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presumptions:[18] first, the tax paid is less than 75%; second, all income earned by the company belongs to those income categories that are to be included in the tax base of resident shareholders; and third, the amount of income earned by the shareholders is 15% of the acquisition value of participation. These presumptions that shift the burden of proof, that is then placed on the taxpayer, can be rebutted by, for example, demonstrating that the income is derived from a genuine business activity or that the tax paid is effectively higher than 75%. However, the Tax Administration still bears the burden of proving control by the taxpayer of the non-resident company.[19]

It should be noted that the Spanish legislation refers specifically to the tax paid by the non-resident entity corresponding to the income that should be included in the shareholder's tax base. Hence, this is neither the accrued tax, nor the total tax paid by the non-resident entity. Tax paid includes the amount effectively paid plus any withholding tax, but using this yardstick gives rise to a negative effect on the fiscal incentives granted to the non-resident company, since these incentives reduce the total tax paid, and as a result it becomes easier to meet the 75% threshold.

However, this rule causes some dysfunctions that are beneficial to the Spanish tax authorities, for example in cases of non-payment of a similar tax abroad by the non-resident entity, or when a deferral of the tax payment or payment by instalment is requested. On the other hand, it is disadvantageous when the non-resident entity satisfies a higher amount and subsequently requests a tax refund on the amount paid. For these reasons the criterion of tax due[20] instead of the effective amount of tax paid is more appropriate.

[18] These presumptions will not apply if the accounts of the participated entity are consolidated within the meaning of Article 42 of the Code of Commerce.

[19] CALDERÓN GONZÁLEZ, J.M., "La transparencia fiscal interna e internacional: su regulación en al Ley 4371995, de 27 de diciembre, del Impuesto sobre Sociedades y en la Ley 40/1998, de 9 de diciembre, del Impuesto sobre la Renta de las Personas Físicas", *Quincena Fiscal*, Núm. 18/2001, *Westlaw* BIB 2001/2435.

[20] ALMUDÍ CID, J.M., supra n. 1 at p. 1.034.

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Since the effective amount should include any similar tax[21] on all earned income, whether or not it is paid in the State where the non-resident company is resident, Spanish non-resident income tax (IRNR) (applicable to both natural and legal persons) must be taken into account if the non-resident company engages in business operations also in Spain.

However, the amounts paid due to other taxes, not analogous to Spanish Corporate Income Tax, are not completely disregarded, because they must be taken into account as tax deductions, thus having an impact on the calculation of the 75% threshold. This is how it should apply to tax on the real estate assets of non-resident entities *(Gravamen Especial sobre Bienes inmuebles de entidades no residents).*[22]

The comparison must be made by applying Spanish Corporate Income Tax severally to each type of income in relation to the amount paid by the non-resident entity. The main point is to apply Spanish Corporate Income Tax to the non-resident entity as if the entity were a Spanish resident company, ignoring the fact that the shareholder can be either a legal or a natural person.[23]

2.3. *Types of income earned by the non-resident company*

Spanish IFT only applies to certain particular types of income. The tax base of the resident shareholder includes any income from the following sources:

a. Income derived from the ownership of real estate. This includes any passive income, such as that deriving from the ownership of rural and urban property or any other rights *in rem* in immovable property, unless they are involved in a business activity or have been transferred for use to non-resident entities, belonging to the same group of companies, even if they are not used for commercial purposes.

[21] Some authors include Wealth Tax in this category. See SANZ GADEA, E., "Transparencia Fiscal Internacional", *Revista de Contabilidad y Tributación*. n. 145 at p. 25; RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 190 ; SANFRUTOS GAMBIN, E., supra n. 13, p. 118.

[22] See Decision 0054-01 of the Directorate-General for Tax.

[23] RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 192.

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b. Income from capital. This passive income includes both participation in profits of other companies (dividends), resulting from participation in the equity of an entity, and interest from loans or a credit due to a capital transfer to third parties. Income from the following financial assets will not be included in this calculation:

- assets that are held to comply with legal and regulatory obligations arising from the exercise of business activities;
- assets arising from contractual obligations pertinent to the exercise of business activities;
- assets derived from broking activities in an official stock market and those derived from business activities by credit institutions and insurance companies.

c. Income derived from capital lending, the provision of services, and other insurance and financial activities. This income that serves to reduce the Spanish tax base includes all income derived, directly or indirectly, from the above-mentioned activities with related resident persons or entities in Spain, with the proviso of being deductible for resident taxpayers, and not related directly or indirectly to exports. The assignment of the company's own capital to third parties will be considered as credit or financial activity, if the following conditions are met: first, the assignor is a non-resident instrumental entity, second, both assignor and assignee belong to the same group of companies, and third, at least 85% of the income of the assignor comes from business activities.

If more than 50% of this income comes from transactions with non-related persons or entities, wherever their residence is, it will be not included in the tax base.

d. Income derived from transferring real estate or securities representing equity participation in an entity. IFT makes it possible to offset profits and losses as long as the final result is positive. It goes without saying that this income is passive in nature.

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e. Income not attributable. However, not all types of income listed above will be taken into account. Even if pertaining to the previous categories, income may turn out to be excluded according to any of the following criteria:

(1) an equity participation of 5% or higher by the non-resident entity in a company obtaining any income falling under earlier points a), b) and d) the income (Article 91.2 in fine LIRPF and 107.2 in fine TRLIS). In addition it is required that the non-resident entity effectively assigns material and human resources to manage this participation in the company and that at least 85% of the income obtained by the company comes from business activities.

(2) The *de minimis* rule (Articles 91.3 LIRPF and 107.3 TRLIS). According to this rule, any income falling under earlier points a), b) and d) will not be taken into account, if the amount is less than either 15% of total income (as determined below) or 4% of total revenues of the non-resident entity, at the discretion of the taxpayer. Spanish IFT allows for the application of this *de minimis* rule with regard to the company group as defined by Article 42 of the Code of Commerce. It is important not to confuse this *de minimis* rule with a non-taxable threshold amount.[24] If both percentages are exceeded, the entire income will be subject to tax. Nevertheless, it has been noted that, "the absence of a limit on the maximum amount combined with the elevated percentage applicable on income makes this *de minimis* rule (…) extremely lenient".[25]

(3) The nature of the expenditure. Corporation Income Tax Law excludes income when it does not qualify as tax deductible for resident companies in Spain (Article 107.2 TRLIS).

(4) The amount of attributed income may not exceed the total income of the non-resident entity (Articles 91.3.3 LIRPF and 107.3.3 TRLIS). The IFT regime defines total income as the tax base amount resulting from applying to this income the principles and criteria of Spanish Corporation Tax (Articles 91.6 LIRPF and 107.7 TRLIS).

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[24] RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7. at p. 188.
[25] SANZ GADEA, E., supra n. 11, at p. 13.

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3. The subjective dimension of IFT

3.1. *Taxpayers*

IFT rules apply to both natural persons and legal entities resident in Spain. As a result, they affect individual as well as corporate income taxpayers. If the three legal requirements already mentioned are met, taxpayers are compelled to include income in their tax base, as long as they participate, either directly in a non-resident entity or indirectly through another non-resident company, in which case the amount of positive income attributed should be measured according to this indirect participation (Articles 91.4 LIRPF and 107.5 TRLIS). Since permanent establishments lack legal personality, as they are neither personal income taxpayers nor corporate taxpayers, IFT will not apply. Nonetheless, permanent establishments are subject to non-resident income tax (IRNR).

3.2. *The non-resident entity*

In order to apply the IFT regime, non-resident entities include any entity with the sole exceptions of civil law partnerships and those entities falling under Article 35.4 General Tax Act,[26] to which the income allocation system applies.[27]

IFT rules will not be applicable to permanent establishments of Spanish companies located in territories or states with preferential or low tax regimes, because they do not have a legal personality distinct from the parent company, and as a result the IFT regime applies to permanent establishments of the controlled foreign companies.

The non-resident company must be a controlled company, and as a result it excludes from the scope of IFT foreign parent companies of Spanish subsidiaries, and also foreign companies belonging to the same group, but not under the control of the Spanish company.[28]

[26] ALMUDÍ CID, J.M., supra n. 1, at p. 1023.
[27] SANFRUTOS GAMBIN, E., supra n. 13, at p. 114.
[28] RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 176.

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Although Spanish IFT does not require non-resident entities to have at their disposal any infrastructure, facilities or a minimal establishment in the country where they reside, these factors, as we have seen, are taken into account for excluding or including certain forms of income.

4. Rules for determining and distributing taxable amounts in IFT

After reviewing the different kinds of income resulting in the implementation of IFT, we now discuss the rules for determining taxable amount and their application to taxpayers. The positive income amount included in the tax base of a resident natural or legal person will be calculated following the principles and criteria laid down in the Corporation Income Tax Act (Articles 91.6 LIRPF and 107.7 TRLIS). For this reason, the losses of a foreign subsidiary in Spain are not attributed: since no tax liability would arise in Spain, the privileged tax regime requirement would not obtain in this case.

Furthermore, reinforcing the attribution of positive income Spanish IFT only allows the taxpayer to offset positive and negative amounts within the same income category.

With regard to individuals, the tax base will not include the tax paid by the non-resident entity as a tax identical to or analogous to Spanish Corporate Income Tax (Article 91.3 in fine LIRPF). This makes sense because these payments cannot be deducted from the tax amount in relation to Personal Income Tax (Article 91.8 LIRPF). The opposite is the case in relation to Corporation Income Tax, where those taxes paid are included in the tax base and subsequently deductible (Article 107.8 TRLIS).

However, this situation is deemed discriminatory against income obtained abroad directly by a natural person (i.e. outside a controlled company context), where Article 80 LIRPF allows the deduction of such taxes paid.

In calculating total income, it is necessary to apply the exchange rate current at the end of the fiscal year of the non-resident entity (Articles 91.6 LIRPF and 107.7 TRLIS). When the IFT taxpayer transfers equity in the non-resident company, the income from this transaction is calculated by

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subtracting from the sale price the acquisition value increased by positive undistributed income that has been charged in the time between acquisition and sale. This adjustment of the acquisition value works as a mechanism to avoid double taxation.

There is a special rule for calculating the sale price when the main activity of the non-resident company is managing immovable or movable assets. This will be at least the theoretical value set forth in the latest balance sheet, once the book value of the assets is replaced by the lesser of these two values: the market value and the one resulting from applying Spanish Wealth Tax rules (Articles 91.9 LIRPF and 107.10 TRLIS).

The actual amount of income included in the taxpayer's tax base is to be determined, preferably, in proportion to their direct or indirect participation in the profits and, failing that, in the capital, equity or voting rights in the foreign company. (Articles 91.1 a) LIRPF and 107.1 a) TRLIS). These different criteria are intended to cover the various legal options permitted in other legal systems. For example, in some domestic laws, there are entities, such as trust or foundations, where the person in receipt of income has no equity participation.

5. Tax period

The application of IFT depends on compliance with the mandatory requirements at the end of the fiscal year of the non-resident entity. As a result, this date determines the corresponding tax period. The duration of this period cannot be more than twelve months. However, IFT allows resident taxpayers to choose the tax period corresponding to the date of the approval of the annual account, provided that this takes place within the six-month period after the end of the fiscal year.

The resident taxpayer must make this option when filling in the first tax returns and the option may not be changed at least three years (Articles 91.5 LIRPF and 107.6 TRLIS). The application of the accrual criterion set forth in the Corporation income Tax Act might be contrary to the ability-to-pay principle laid down in Article 31 of the Spanish Constitution, because it

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does not address the consequences that payment defaults or insolvency suffered by the non-resident company may have on shareholders.[29] According to IFT rules, the resident taxpayer should be taxed on income that the non-resident company may never receive.

6. The avoidance of double taxation

IFT rules can result in two cases of double taxation: domestic (by taxing a dividend before it has been paid) and international (by taxing income that has been already taxed in another state).

6.1. *Domestic double taxation*

In order to prevent internal double taxation, IFT merely provides that actual dividends or shares in profit will not be calculated as part of the tax base as the corresponding proportion of positive income already included in the tax base (Articles 91.7 LIRPF and 107.8 TRLIS). This means that, strangely, Spanish IFT applies even in the case of dividends regularly distributed, which could be in contrast with EU law as it lacks the proportionality that the Court of Justice of the European Union (CJEU) established in the *Cadbury* case.

Furthermore, IFT attempts to address the anticipated distribution of dividends by non-resident entities by applying the same rules. In this case, having been charged at the time of the actual distribution, IFT would also apply afterwards with regard to a subsequent tax period. Although Articles 91.7 LIRPF and 107.8 TRLIS state that "any positive income shall be included in the tax base once only, whatever the legal form it may have", this provision is insufficient, in the opinion of a number of authors, because it applies to "doubly charged tax bases but not to cases in which the income of the non-resident controlled company has been included in the

[29] ALMUDÍ CID, J.M., supra n. 1, at p. 1053.

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shareholders' tax bases in previous tax periods".[30] This would be considered to be double taxation, and thus contrary to the ability-to-pay principle enshrined in Article 31.1 of the Spanish Constitution.

In the case of the distribution of reserves, the assignment norm enclosed in the company agreement should be adopted, along with the application of the LIFO method, that is, the most recent amount paid should be deemed to referr to these reserves.

6.2. *International double taxation*

With regard to the avoidance of international double taxation, Spanish IFT distinguishes between natural and legal persons (Articles 91.8 LIRPF and 107.8 TRLIS).

Legal persons may deduct from tax due any taxes actually paid as a tax identical or analogous to Spanish Corporate Income Tax, in proportion to the positive income included in their tax base. It is necessary to consider any tax actually paid by both the non-resident entity and any participated company if the participation amounts to 5% or more. In contrast with the general rule, the IFT regime does not allow the application to subsequent tax periods of an amount the deduction of which had proved impossible due to the insufficient amount of tax paid. This differential treatment has no justification, and as a result it should be considered to be in violation of Article 31.1 of the Spanish Constitution since this case of double taxation cannot be prevented.[31]

For both legal and natural persons, IFT allows the deduction of tax paid abroad "due to the distribution of dividends or shares in profit, in accordance with the provisions of a double taxation convention or a domestic rule, for the part corresponding to positive income previously included in tax base". This deduction can be made even if the taxes paid refer to a different tax period from the one in which the income was included in the tax base.

[30] ALMUDÍ CID, J.M., supra n. 1, at p. 1056.
[31] ALMUDÍ CID, J.M., supra n. 1, at p. 1058.

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In the case of countries or territories deemed to be tax havens, the deduction of taxes paid is not allowed, either for personal nor corporate income tax. Whereas this provision is consistent with the personal income tax system, it is not with regard to corporate income tax. In fact, IFT does not allow natural persons any kind of deduction of tax paid abroad (Article 91.8 LIRPF) because it was previously not included in the tax base (Article 91.3 in fine LIRPF). However, with regard to corporate income tax, this absolute ban on deduction enshrined in paragraph 9 Article 107 TRLIS[32] is somewhat contradictory, since, as we have seen before, paragraph 12 allows taxpayers to present a rebuttal to the presumption of privileged taxation in tax havens by proving that the tax actually paid is higher than 75%. Arguably, this possibility of adducing effective payment should also allow for a deduction or, at least, the exclusion of this amount from the tax base. Otherwise this could arguably be considered a violation of the ability-to-pay principle laid down in Article 31.1 of the Spanish Constitution.[33]

Finally, it is evident that the global deductible amount from IFT cannot exceed the tax due corresponding to positive income included in the tax base (Articles 91.8 LIRPF and Article 107.9 TRLIS).

7. Formal tax obligations

Taxpayers to whom IFT is applicable must, in addition to the corresponding tax return, supply the following data pertaining to the non-resident entity:

- the name or the business and place of registered office;
- the list of directors and/or managers;
- the balance sheet and the profit-and-loss account;
- the amount of the positive income to be included in the tax base and
- evidence of the tax paid regarding that positive income (Articles 91.10 LIRPF and 107.11 TRLIS).

[32] The general rules on avoiding international double taxation do in fact exclude them (Art. 31 TRLIS).

[33] ALMUDÍ CID, J.M., supra n. 1, at p. 1.058

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8. The IFT regime and the OECD Convention Mode

There is some doubt about the compatibility of Spanish IFT with Double Taxation Conventions (DTCs) following the OECD Model Convention (OECDMC), because Articles 7.1 and 10.5 lay down, respectively, the principle of independent taxation of the entities from their partners in relation to "business profit" and a prohibition on taxing company profits before their actual distribution. Spanish legal opinion is divided on this issue, depending on the legal value that each author grants to the comments to the Model Convention.[34]

The comments to the Model Convention are favourable to the compatibility opinion. In this sense, comment 23 to Article 1 OECDMC (2012) asserts that "It has sometimes been argued, based on a certain interpretation of provisions of the Convention such as paragraph 1 of Article 5 and paragraph 5 of Article 10, that this common feature of controlled foreign companies legislation (a contracting state taxing each resident on income attributable to their participation in certain foreign entities) conflicted with these provisions. For the reasons explained in paragraphs 14 of the Commentary on Article 7 and 37 of the Commentary on Article 10, that interpretation does not accord with the text of the provisions. It also does not hold when these provisions are real in their context".

Nevertheless, the Spanish tax authorities however unambiguously have maintained this compatibility since the inception of IFT (e.g, the decision of the Directorate-General for Tax of 10 November 1995) and have confirmed it more recently by signing new DTCs explicitly affirming the compatibility between the two sets of rules.

IFT regulation specifically addresses its relation to DTCs by stating that IFT will apply without prejudice to the provisions laid down in international conventions (Article 91.12 LIRPF and Article 107.13 TRLIS). Until recently, DTCs ratified by Spain did not refer to this issue, but since 2006 they

[34] Contra, ALMUDÍ CID, J.M., supra n. 1, at pp. 1060-ff.; GONZÁLEZ POVEDA, L, "Comentarios sobre la nueva transparencia fiscal internacional. Repercusión en la actividad exterior de las sociedades españolas", *Impuestos,* tomo II, 1995, at pp. 240-242.

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explicitly affirm the compatibility between the two sets of rules.[35] This compatibility is also assured by Articles 107 .9 b) TRLIS and 91.8 para. 1 LIRPF allowing the deduction of tax paid abroad "due to the distribution of dividends or shares in profit, according to an *agreement to avoid double taxation (…)*, in the part corresponding to positive income previously included in tax base".[36]

The OECD has maintained the compliance of CFC with DTCs, subject to certain recommendations.[37]

First, CFC would be contrary to a bilateral agreement if it affected genuine business activities actually performed in the country or territory in which the concerned entity resides. As mentioned above, Spanish IFT complies with this requirement, because it targets only passive income and certain business income aimed at eroding the tax base of companies resident in Spain. However, since 2003 the reference to business activities as a restriction for the implementation of the IFT has been deleted from the comments to the OECDMC.

Second, CFC should not apply in relation to countries where the level of taxation is similar to that of the country of residence of the taxpayer. In the analysis of privileged tax regimes above, we saw that Spanish TFI fails to comply with this recommendation.

Third, CFC would be in contrast with the principles underlying the international convention if they resulted in double taxation. The Spanish IFT complies with this requirement partially, due to the different tax deductions applicable to the income tax of natural and legal persons. Personal income tax law does not allow the deduction of taxes paid abroad by non-residents while the law on corporate income tax does.

9. IFT and European Union law

[35] See DTCs with Switzerland (2006); Moldova (2007); Bosnia-Herzegovina and Jamaica (2008), Trinidad and Tobago, Serbia and Uruguay (2009); Albania, Armenia and Barbados (2010); and Singapore (2011), where it is stated that "this Convention shall not prevent the Contracting States from applying their domestic laws regarding IFT".

[36] SANZ GADEA, E., supra n. 2, at p. 154.

[37] RODRÍGUEZ ONDARZA, J.A. y RUBIO GUERRERO, J.J., supra n. 6, at p. 146; RODRÍGUEZ-PONGA SALAMANCA, E., supra n. 7, at p. 218.

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Spanish IFT can be problematic in terms of compatibility with EU primary and secondary EU law. We now deal with these issues in that order.
Regarding the primary EU law, IFT regulation might constitute an obstacle to capital flow from residents to non-resident entities, due to possible double taxation issues and to obligations imposed on resident taxpayers.
Actually, this obstacle or restriction could affect both freedom of establishment in other Member States (if taxpayer participation is equal or greater than 50%, because effective control of the entity is acquired) and the free movement of capital within the EU and third countries (if taxpayer participation is less than 50%, because we have to bear in mind that the control requirement can be ascertained combining related persons and parties).
Spanish legislation has been amended twice following the requirements of EU law as laid down in the case law of the Court of Justice of the European Union (CJEU).
The first amendment came in response to the CJEU Judgment of 12 December 2002, *Lankhorst-Horost* C-324/00, relating to thin capitalization. Act 62/2003 of 30 December, on fiscal, administrative and social measures, stipulated that the IFT regime, for personal income[38] tax as well as for corporate income tax purposes, "shall not apply when the entity not resident in Spanish territory is resident in another Member State of the European Union, unless residing in a territory classified as a tax haven". As a result, IFT does not apply to EU Member States, thus apparently dealing with any compatibility problem with the EU legal order. However, this is not the case for two reasons. First, because the fundamental EU freedoms also apply to the European Economic Area States, and the EU freedom of capital movement covers third countries. Second, because the Spanish regulation deems as tax havens two Member States that joined the EU in 2004, Malta and Cyprus.
Moreover, this restraint of the application of Spanish IFT to companies residing in other Member States might have proved to be excessive, since the CJEU in its judgment of 12 September 2006, *Cadbury Schweppes and*

[38] This wording stands in current Article 91.13 LIRPF.

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Cadbury Schweppes Overseas, C-196/04,[39] admits under certain conditions the compatibility of IFT with EU law, in particular with the freedom of establishment.

Although IFT is a restriction on the freedom of establishment and capital movement, it may be legitimate in cases of abuse or fraudulent use of these freedoms, provided that the measure is justified by overriding reasons of public interest and provided that it is proportionate. The CJEU ruled that the constitution of a company "for the avowed purpose of benefiting from the favourable tax regime which that establishment enjoys does not in itself constitute abuse" (p.38) and therefore, cannot justify the restriction of these freedoms. Naturally, this statement draws attention to another requirement of Spanish IFT, that is, the identification of areas with preferential or low tax, which in itself loses relevance, since seeking a privileged tax regime is not against EU Law. The CJEU ruled that though IFT can be justified "on the ground of prevention of abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory" (p.55).

In assessing the proportionality adopted to deal with CFC, the CJEU considered in particular the fact that CFC regulation foresee exceptions to its application in "situations in which the existence of a wholly artificial arrangement solely for tax purposes appears to be excluded" (p.61). This would be case where the controlled entity distributes almost all of its profits to a resident company, which is completely disregarded in the Spanish IFT, or carries on business activities.

The CJEU builds its position on the basis of a vague concept, a "wholly artificial arrangement". On the way to clarifying this legal concept, it considered that the finding of the existence of this arrangement requires "in addition to a subjective element consisting in the intention to obtain a tax advantage", objective evidence indicating that "the objective pursued by

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[39] See CJEU Order of 23 April 2008, *Test Claimants in the CFC and Dividend Group Litigation*, C-201/05.

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freedom of establishment,(…), has not been achieved" (p.64). This objective requires "an economic activity through a fixed establishment in that State for an indefinite period" (p.54), and "presupposes actual establishment of the company concerned in the host Member State and the pursuit of genuine economic activity there" (p.54). Such a negative finding, incumbent on national judges, "must be based on objective factors which are ascertainable by third parties with regard, in particular, to the extent to which the CFC physically exists in terms of premises, staff and equipment" (p.67).

Thus, if the scope of CFC is limited to these wholly artificial arrangements, such as a 'letterbox' or 'front' subsidiary, CFC will be in compliance with EU law, provided that it rules out "where it is proven, on the basis of objective factors which are ascertainable by third parties, that despite the existence of tax motives that CFC is actually established in the host Member State and carries on genuine economic activities there" (p.75).

Bearing in mind the connection between the objective pursued by freedom of establishment that CFC must abide by, it appears that regulations following the "entity approach", like the United Kingdom CFC, are the most appropriate. However, this claim, in my opinion, is not final. If we consider the freedom of capital movement, the "transactional approach" could make more sense.

From this 'freedom of establishment' perspective, this judgment showed that Spanish IFT suffered from important shortcomings.[40] It does not refer to "wholly artificial arrangements aimed at circumventing the application of the legislation of the Member State concerned" (p.51), nor was it drafted "to prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality" (p.55). As a result, the IFT regime is applied without taking account of the exact nature of the non-resident entity, notably whether or not its "incorporation must correspond with an actual establishment intended to carry on genuine economic activities in the host Member State" (p.66). Finally, IFT Spanish regulation was also

[40] MALHERBE, J., et al., "Atribución de rentas en el caso de sociedades extranjeras controladas", *Civitas Revista Española de Derecho Financiero*, num. 141, 2009, at p. 155.

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defective regarding the following requirement as laid down by the CJEU: "The resident company, which is best placed for that purpose, must be given an opportunity to produce evidence that the Controlled Foreign Company is actually established and that its activities are genuine" (p.70).

This judgment elicited the second amendment of IFT regime. Act 4/2008 of 23 December redrafted Article 107.15 TRLIS concerning only corporate income tax, laying down that IFT "shall not apply when the non-resident entity in Spanish territory resides in another Member State of the European Union, provided that the taxpayer produces evidence that the constitution is due to real economic reason and that carries on genuine business activities".

Although it did not explicitly use the term "wholly artificial arrangements", this amendment was aimed at covering these deficiencies listed above and at bringing Spanish IFT into line with EU freedom of establishment.[41] In my opinion, this change introduces into Spanish law elements pertaining to the "entity approach" as applied in the United Kingdom (which was actually the merit of case), that are extraneous to the "transactional approach" applied in Spain.

This reworded article provided for a rebuttable presumption of IFT application, unless the resident taxpayer proves the conditions, thus dealing with a weak point in the previous regulation. At the same time, the article removes the reference to tax havens, that is difficult to maintain in relation to EU Member States, though the status of territories deemed to be tax havens, such as Gibraltar, remains unclear.

When it comes to IFT with regard to personal income tax, an important request from the European Commission[42] for an amendment to Spanish law has not yet been dealt with. Although the scope of IFT excludes other Member States, it includes tax havens and EEA States and, in the Commission's opinion, it is contrary to Community law, since "it goes beyond what is necessary, since it is applicable not only to wholly artificial

[41] In this connection, it should be borne in mind that "OECD comments do not limit the application of IFT to the aim of combatting wholly artificial arrangements» (SANZ GADEA, E., supra n. 2, at p. 158.

[42] Document IP/08/342, of 28 February 2008.

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arrangements but also to parent companies controlling subsidiaries carrying out genuine economic activities in those Member States or territories”.

As to EU secondary law, the main issue is the compatibility of IFT with Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States. It is well known that the objective of this Directive is to eradicate double taxation on the profits that a parent company has received from its subsidiary, either by refraining from taxation or by allowing the deduction of the tax paid by the subsidiary in relation to such profits. The Directive does not explicitly exclude dividend imputation and in Article 1.2, it allows for the application of national provisions to prevent fraud and abuse. As a result, Spanish IFT could be seen as compatible with the Directive, since it provides a mechanism for deduction similar to the one laid down in the Directive (Art. 107.9 a)[43] TRLIS).[44]

Finally, it should be mentioned that the Directorate-General for Tax contended, in its decision of 10 November 1995, that the Convention 90/436/EEC on the elimination of double taxation in connection with the adjustment of profits of associated enterprises should not apply when the “income derived by a resident entity in one Contracting State is included in the tax base of another entity that controls the former and resides in another Contracting State, when this latter State applies to the entity IFT rules”.

10. Conclusions

Spanish IFT is characterized by significant shortcomings from a legal point of view. Some of these deficiencies are inherent to the Spanish legislative choice distinguishing between natural and legal persons without giving a substantial reason for it. This dichotomy is reflected throughout the IFT regime, such as the requirements to be met for its application or for

[43] 107.9 a) TRLIS

[44] GARCÍA HEREDIA, A., “La inversión española en la Unión Europea: Transparencia fiscal internacional”, in *Internacionalización de las inversiones. Tratamiento fiscal en España y en la Unión Europea*, Bosch, 2009, at. pp. 358-359.

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avoiding international double taxation, as OECD guidelines demand. This twofold regulation is particularly problematic with regard to the applicability and compatibility of IFT with EU law. In conclusion, this legal regime displays certain serious shortcomings resulting in legal provisions that appear to be in contrast with basic constitutional principles on tax justice, equality and the ability to pay.

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