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Spain's Supreme Court recently issued two judgments denying corporate income tax deductions for the remuneration of directors of a public limited company (PLC). The November 13, 2008, judgments (2578/2004 and 3991/2004), which were only recently made public, have caused quite a debate.

The Tax Inspectorate had initiated two separate proceedings against a PLC, claiming that the directors' remuneration it had included as a deductible expense did not qualify.

After exhausting all appeal procedures, the company brought its case to the Supreme Court, which also concluded that the directors' remuneration was nondeductible. The company's bylaws described the directors' remuneration as "a fixed amount that could be reviewed annually, in addition to a share of the company's profits in line with the limits laid down by legislation."

In its interpretation of the current Public Limited Companies Act and of section 13(f) of the Corporate Income Tax Act 1978 (now abrogated), the Court concluded that for the remuneration of the directors of a PLC to be tax deductible, the company bylaws must specify the directors' remuneration "with certainty." The remuneration will be considered certain if it meets the following conditions:

- (a) the bylaws must specify a definite earnings system and not contemplate several systems from which the board of directors can choose;
- (b) for variable earnings based on profit sharing, the bylaws must establish a definite percentage, and not a maximum percentage; and
- (c) for fixed earnings, the bylaws must establish a definite amount, or alternatively, must establish criteria to calculate the exact amount without leaving scope for discretion.

The Court's conclusions, which appear to diverge from the current corporate income tax regulation, could have significant practical repercussions.

The finding on fixed remuneration in point (c) is particularly controversial because the bylaws of many companies define directors' remuneration as a fixed amount to be established every year by the general shareholders meeting.

Points (a) and (b), on the other hand, reflect existing common practice: The bylaws must specify the earnings system, and, in the case of variable earnings, they must specify a definite percentage of profit sharing.

Under the previous regulation on corporate income tax (section 13(f) of the Corporate Income Tax Act 1978) applicable to the fiscal years subject to the Supreme Court's analysis, for an expense to qualify as tax deductible, it must be a mandatory expense and, therefore, necessary for the company to engage in its activity.

The current regulation does not refer to those requirements. It states that an expense is considered tax deductible if the company enters it into its books and meets the conditions of the
commercial regulation on directors' remuneration. Thus, controversy may arise if the tax authorities rely on the Supreme Court's judgments and not on the criteria of the Directorate General of Registries and Notarial Affairs (Dirección General de los Registros y del Notariado), concluding that companies that do not specify the remuneration amount in their bylaws are in breach of the commercial regulation. This would result in the remuneration of the directors not being tax deductible.

This risk is limited to PLCs and does not extend to limited liability companies (the most common type of company in Spain). Under section 66.3 of the Limited Liability Companies Act, fixed remuneration "will be set every fiscal year by agreement of the shareholders general meeting." The act itself thus prevents LLCs from establishing a definite amount in their bylaws, stating that the shareholders general meeting must set the amount annually.

The Court's judgments of November 2008 are especially relevant for listed PLCs. The Spanish tax authorities may consider that the remuneration those companies pay to their directors is nondeductible if their bylaws do not specify a definite remuneration amount, or alternatively, the criteria needed to calculate the exact amount without leaving scope for discretion. Therefore, it is important to pay close attention to how the tax authorities interpret the judgments in the context of the current wording of the Corporate Income Tax Act.

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Tax Analysts Information
Jurisdiction: Spain
Subject Area: Corporate taxation
Legislative tax issues
Litigation and appeals
Author: Martinez, Ana; Velasco, Sonia
Document Number: Doc 2009-1598