Spain

The Application of Spanish CFC Rules to Investments in EU Alternative Funds: Current Overview and the Impact of the ATAD Directive

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This article focuses on the application of the Spanish controlled foreign company (CFC) rules to EU alternative investment funds (AIFs) as defined in article 4(1)(a) of Directive 2011/61/UE of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFM Directive). The focus of the article is in particular on AIFs managed by AIF managers that meet all the requirements of the AIFM Directive and, therefore, can be freely distributed throughout the European Union at least among professional investors.

1. EU Alternative Funds

This article focuses on the application of the Spanish controlled foreign company (CFC) rules to EU alternative investment funds (AIFs) as defined in article 4(1)(a) of Directive 2011/61/UE of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFM Directive). The focus of the article is in particular on AIFs managed by AIF managers that meet all the requirements of the AIFM Directive and, therefore, can be freely distributed throughout the European Union at least among professional investors.

The main objective of the AIFM Directive is to establish an internal market for AIF managers and a harmonized and rigorous framework for supervising activities of those managers within the European Union.

The scope of the AIFM Directive is focused, fundamentally, on the managers of AIFs, regardless of whether the funds are open-ended or closed-ended, their legal form or whether they are listed or not. The AIFM Directive, unlike the Directive on undertakings for collective investment in transferable securities (UCITS Directive), does not regulate the funds themselves, i.e. it does not establish a common framework for the harmonization of funds, which are still regulated and supervised by each national authority. In other words, the AIFM Directive does not prevent Member States from applying its particular national requirements in relation to AIFs established in their territory.

The AIFM Directive establishes very stringent rules regarding the activities that AIF managers can develop; the need to obtain authorization; managers' capitalization requirements; managers' experience and good repute; the suitability of partners; demanding operational requirements; remuneration rules; conflicts of interest; risk management; liquidity management; and highly relevant requirements of organization, material and human resources and asset valuation.

Qualification as an AIF manager imparts the ability not only to manage an AIF incorporated in its Member State, but also to develop cross-border management of an AIF incorporated in other Member States.

The AIFM Directive also establishes a highly relevant regulatory and liability regime for the depository of the assets of the fund.

The AIFM Directive, in addition to its main objective, establishes a common commercialization framework throughout the European Union (only between professional investors) of AIFs managed by AIF managers. In this scenario, the authorization requirement to distribute the AIF is precluded for managers who meet the AIFM Directive requirements. There is no need to obtain authorization to distribute the AIF in different EU jurisdictions – a communication to the supervisor is enough.

No reference to tax rules is contained in the AIFM Directive. It could be said, however, in general terms, that EU AIFs are low taxed and, in most cases, their income and gains are not taxed under corporate income tax generally applicable in the relevant jurisdiction.

2. The Spanish CFC Rule

The CFC regime is established in article 100 of the Spanish Corporate Income Tax (CIT) Law[1] and in article 91 of the Spanish Personal Income Tax (PIT) Law.[2]

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1. Law 27/2014 of 27 Nov. 27 (CIT Law).
2. Law 35/2006 of 28 Nov. 28 (PIT Law).

In general terms, the aforementioned regime entails the allocation, in the taxable base of the Spanish resident investor, of certain passive income and gains (i.e. basically not derived from business or professional activities) obtained by a foreign subsidiary (directly or indirectly participated), as long as certain requirements contained in the Spanish legislation, related to control and to zero or reduced taxation, are met. This allocation takes place regardless of the income that is effectively distributed to the shareholder.

The application of the CFC regime requires a direct or indirect participation of at least 50% in share capital, results, voting rights or equity of the non-resident entity. It also requires that the non-resident entity is taxed on the passive income, under an identical or analogous tax to Spanish CIT, for an amount lower than 75% of the amount resulting from the application of the Spanish CIT rules.

If such requirements are met, the Spanish legislation distinguishes the following two tax treatments for the investor:

– a general allocation rule that implies including in the Spanish investor's taxable base the total income and gains obtained by the non-resident entity when it does not have the corresponding organization of material and human resources to carry out its activity;[3] and
– the allocation, in the taxable base of the Spanish resident investor, of the following passive income (i.e. not derived from business or professional activities): (i) income arising from the ownership of real estate, rustic or urban, not connected to business activities; (ii) dividend and interest income; (iii) certain income derived from certain financial activities, insurance activities and service provision activities; (iv) income arising from the transfer of non-business connected real estate, shares or debt securities; (v) insurance and capitalization transactions when the foreign entity is the beneficiary; and (vi) income derived from derivatives.

The general allocation rule prevails over the list of passive income allocation. The mentioned list becomes relevant, therefore, once it has been verified that there are material and human resources for the development of the activity of the non-resident entity.

Under this scenario, it must be noted that the application of the CFC rule is excluded when the foreign company in whose share capital the investors hold a percentage of control is resident for tax purposes in the European Union, as long as it can be proven that *"its incorporation and activities respond to valid economic reasons and that it performs business activities"*.

It should also be pointed out that the application of the CFC rule is excluded, directly, without any further requirements, when the non-resident entity in Spain is a collective investment institution harmonized under the UCITS Directive, and domiciled and incorporated in any EU Member State that is not considered a tax haven. In this case, there is no need to prove the existence of valid economic reasons, nor the performance of any business activity. It is a subjective exemption.

The question arises when a Spanish investor, alone or together with other related parties, holds 50% or more of the shares or units in a non-Spanish EU AIF, for instance a Luxembourg specialized investment fund (SIF) or reserved alternative investment fund (RAIF). These vehicles are not taxable under Luxembourg CIT. Normally they obtain passive income and gains and, consequently, can be subject to Spanish CFC rules in principle, since they are not UCITS-harmonized funds.

Under Spanish legislation, the only way to exclude such types of funds, a priori, from application of the CFC legislation is to prove that they were incorporated for valid business reasons and that they carry on business activities.

Section 3. proceeds to analyse such concepts under Spanish domestic legislation.

3. Interpretation of Key Concepts within the Framework of Spanish CFC Rules and Its Impact on AIFs

There is no administrative doctrine or case law that exactly interprets the concepts of "performance of business activities" and "valid economic reasons" within the scope of the application of the CFC tax regime. Therefore, the only option is to apply general interpretation principles from Spanish tax law.

3.1. The performance of "business" or "economic" activities

In Spanish domestic tax legislation, in particular related to direct taxes, the concept of economic or business activity has been rather restrictive.[4]

The definition contained in the PIT Law is too broad and ambiguous, but it is extremely hard to interpret that the holding of financial assets is to be regarded as a business activity.

The CIT Law introduced a new article 5, which provides a general concept of business activity for the purposes of CIT that does not differ substantially from the definition of economic activity contained in the PIT Law, although it is a bit more flexible when investments are made in the equity of active business companies above 5%.

3. The type of income that is obtained is irrelevant. The important thing is whether the means to carry out the activity exists or not. It is expressly accepted that the allocation will not be applicable when the taxpayer proves that the activity has been carried out with the material and human resources of a non-resident entity belonging to the same group within the meaning of art. 42 Commercial Code, or that their constitution and operation respond to valid economic reasons.
4. The current art. 27 PIT Law establishes that: "Income from business activities means all such income from employment and/or from capital, as entails the organization by the taxpayer for its own account of means of production and/or human resources, with a view to participating in the production or distribution of goods or services".

In any case, according to the definition contained in the PIT and the CIT Law, it should likely be interpreted that EU AIFs, whose activity consists of holding investments in financial assets and, normally, in the case of equity investments, in percentages below 5%, are not regarded as carrying out a business activity for the purpose of excluding automatically the application of Spanish CFC legislation.

A similar result would be achieved if the concept of business activity that has been traditionally used in the Spanish net wealth tax legislation were applied.

Consequently, within the framework of Spanish domestic legislation related to direct taxation, at least in the manner in which it has been interpreted by the tax authorities and courts to date, it is unlikely that investment activities such as those carried out by EU AIFs would be classified as business or economic activities.

It is obvious that the AIF manager carries on a business activity, even by the standards of the Spanish PIT, CIT and net wealth tax legislation, but not the fund itself. The fund itself is just a passive investment vehicle that does not manage any investments – except, of course, if the AIF itself were an AIF manager, i.e. that the fund itself has the structure required by the AIFM Directive to also be an AIF manager. The Directive allows AIFs that are also AIF managers to exist and, in such cases, in the authors' opinion, the requirement for carrying on a business activity would certainly be met. However, it must be said that, in practice, it is a very rare occurrence. Normal practice would be for the fund to be managed by an external AIF manager, since managers habitually manage not only one fund, but many. In this more usual scenario, the fund itself is just a passive vehicle that holds the investments, but it cannot be said to carry on an asset management business activity (which, in this last case, is actually carried out by the third-party AIF manager).

The comments in this article will focus on this more usual case, which is certainly excluded from the concept of business activity as traditionally used in Spanish domestic legislation.

3.2. Incorporation for valid economic reasons

It is worth noting that the concept of valid economic reasons, at least in Spanish domestic legislation, appears related to objectives fundamentally different from achieving tax advantages. It has been interpreted to mean that the simple obtainment of tax advantages can in no way be considered a valid economic reason for performing certain transactions that involve any type of tax credit.

Consequently, from the perspective of the CFC tax regime, it should be sufficient to prove that there are valid economic or business reasons for AIF incorporation and operation if it is not the product of a primary intention to avoid or defer taxes. There should be valid reasons if, among many others, the following, or a combination of them, occur:

- the need to diversify the management of assets in different vehicles and jurisdictions, through an element of prudence and risk control;
- the regulatory flexibility of AIFs in terms of assets and diversification; and
- the interest in the alternative management policy that the AIF manager applies through AIFs.

In any case, the concept of valid economic reasons is an aspect that must be analysed on a case-by-case basis.

3.3. Conclusion

From all the above, the authors can conclude that if we just stick to current Spanish CFC legislation and it remains the same, an EU AIF (such as a Luxembourg SIF or RAIF) managed by a third-party AIF manager will not automatically be excluded from the Spanish CFC legislation. Even if it had been incorporated for reasons other than tax, it would normally be regarded as a low passive vehicle and, therefore, if a Spanish investor held 50% or more of the interest in the AIF, the CFC rules would apply.

However, an approach limited only to the interpretation of Spanish domestic legislation according to exclusively domestic interpretation methods is, in the authors' opinion, insufficient. The EU fundamental freedoms, particularly the freedom of establishment and the free movement of capital, should play a key role in making a correct interpretation of the terms of the Spanish CFC legislation. Section 4. proceeds to comment on the impact of EU principles on the matter.

4. The Interpretation of Spanish CFC Rules according to EU Principles of Freedom of Establishment and Free Movement of Capital

4.1. General comments

In order to interpret the two EU principles of freedom of establishment and free movement of capital in the context of the CFC regulations, reference is made especially to the judgment of the ECJ in the *Cadbury Schweppes* case, case C-196/04, which analyses the compatibility of the UK CFC regime with EU legislation.

In that judgment, the ECJ, based on the basic principles underlying the freedom of establishment, concluded the following: the UK CFC legislation is recognized by the ECJ as a restriction to the freedom of establishment.

However, the ECJ itself recognizes, in line with previous case law, that the restriction may be justified where it specifically relates to avoiding wholly artificial arrangements aimed at circumventing the application of the tax legislation of the Member State concerned. In other words, in order for a restriction on the freedom of establishment to be justified on the grounds of preventing abusive practices, the specific objective of such a restriction must be to prevent conduct involving the creation of wholly artificial arrangements that 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.

In the *Cadbury Schweppes* judgment, the ECJ settled the matter based on the freedom of establishment. However, this criterion (in other words, accepting restrictions on an EU fundamental freedom on the grounds of combating fraud and tax evasion, if the specific purpose of a rule is to prevent wholly artificial arrangements that are void of economic reality and with the only objective of avoiding the tax normally due) has also been consistently applied by the ECJ regarding the free movement of capital.[5]

Consistent with this case law, and of particular relevance because of the similarity with the present case, the ECJ published the judgment of 13 November 2014 in case C-112/14, in which it considers that certain rules of the United Kingdom, which share similarities with CFC treatment, are contrary to the freedom of movement of capital. Indeed, according to the background included in this judgment, the British regulation being challenged basically forces UK residents who hold shares of 10% or more in closed foreign undertakings (i.e. undertakings controlled by no more than five shareholders) to recognize (and, therefore, be taxed on) the earnings obtained by these undertakings, even if not distributed. The relevance is that the British rules exempt earnings from elements related to business activities from such recognition and taxation, which should therefore not be recognized and used to tax the shareholders. Please note the conceptual similarity between the British exception and the Spanish exception from recognition under the CFC rules, if the European undertaking has an economic activity.

However, despite the existence of this exception, the ECJ concludes that the rule breaches the principle of free movement of capital, as it does not apply only to situations in which there is a purely artificial situation aimed at tax avoidance.[6]

Finally, it is important to underline the recent ECJ judgment of 30 December 2017 in joined cases C-504/16 and C-613/16 (*Deister* case and *Juhler* case). Although not referring to CFC or any similar rules, but issued within the interpretation of the German rules transposing the Parent-Subsidiary Directive, the conclusions on the application of the anti-abuse provision of the Directive are particularly relevant for the case at hand:

- as in previous case law, the Court reaffirms its doctrine that a national measure that transposes a directive must be analysed not only in the light of the provisions of the directive that the national rule intends to transpose, but also in the light of the relevant provisions of primary law when the directive has not established exhaustive harmonization at EU level. In other words, the freedom of movement of capital and the freedom of establishment, as interpreted by the ECJ, cannot be breached on the grounds that the national provision transposes a directive when such a directive does not carry out an exhaustive harmonization;
- the ECJ, again following its recurrent doctrine, reaffirms that, in order for national legislation to be regarded as seeking to prevent tax evasion and abuses, its specific objective must be to prevent conduct involving the creation of wholly artificial arrangements that do not reflect economic reality, the purpose of which is to unduly obtain a tax advantage. The ECJ reaffirms the *Cadbury Schweppes* doctrine (as it has done on many occasions), but significantly applies it to give a correct interpretation of an anti-abuse measure contained in a directive, in this case the Parent-Subsidiary Directive;
- the Court makes for a very relevant statement (already included in previous jurisprudence): a general presumption of fraud and abuse cannot justify either a fiscal measure that compromises the objectives of a directive or a fiscal measure that prejudices the enjoyment of a fundamental freedom guaranteed by the treaties; and
- what its truly original of this judgment is that the ECJ gives a very wide definition of economic activity that deserves protection both under the Parent-Subsidiary Directive and under the fundamental freedoms of the treaties – namely, in this case, the freedom of establishment: the fact that the activity of a non-resident parent company consists in the management of its subsidiaries' assets, or that the income of the company results only from such management, cannot, per se, indicate the existence of a wholly artificial arrangement that does not reflect economic reality. The ECJ further states that the fact that the management of assets is not considered to constitute an economic activity for VAT purposes is irrelevant, since the tax at issue in the judgment (a withholding tax, i.e. a tax on income) and VAT (a tax on consumption) are governed by different legal principles and pursue different objectives.

4.2. Conclusions

In the authors' opinion, it is obvious that the anti-abuse standard applied by the ECJ is less strict than the standard foreseen in Spanish domestic legislation in order to exclude a CFC from the application of CFC legislation.

The EU standard does not require the carrying on of a business activity, as interpreted traditionally by Spanish administrative doctrine and courts (which would exclude, for instance, the activities of a typical holding company and certainly the activity of an investment fund). It simply requires that the entity is not a wholly artificial arrangement that does not reflect economic reality and that is aimed at avoiding taxes.

Since Spanish domestic legislation cannot be interpreted in a manner contrary to the EU fundamental freedoms of establishment or of the movement of capital, it is clear that by allowing the application of an EU AIF, covered by the AIFM Directive, the application of the

5. For example, among many other judgments, we can cite that of 3 Oct. 2013, in case C-282/12, as well as those of 7 Nov. 2013, in case C-322/11, and 17 Sept. 2009 in case C-182/08.
6. Paras. 25 and 27.

Spanish CFC rule on the grounds that it does not carry on a business activity (as interpreted by Spanish traditional standards) would be contrary to the ECJ's doctrine. Only to the extent that it is a wholly artificial arrangement aimed at avoiding taxes could such a CFC application be justified.

The question then is why an EU AIF, fully covered by the AIFM Directive, should be seen as a wholly artificial arrangement not reflecting economic reality. Obviously, there is no reason:

- the AIF carries out an activity that, certainly for the purposes of the application of both fundamental freedoms, is an economic activity subject to protection. The wide concept of economic activity given under the *Deister* and *Juhler* cases makes this self-evident;
- the fact that the AIF is covered by the principles of the AIFM Directive and, therefore, can be freely distributed among professional investors through the European Union, implicitly entails that the EU legislator does not consider it a wholly artificial arrangement with no economic reality. Otherwise, would the EU legislator have allowed wholly artificial arrangements with no economic substance to be marketed among different Member States? The answer, clearly, is "no"; and
- in addition to the above, if an authority of any Member State considered that an AIF covered by the AIFM Directive, and therefore distributable within the European Union, could be subject to the application of CFC rules (and therefore could make the investment in such funds less attractive to the authority's own nationals vis-à-vis, for instance, local funds), such a position would certainly entail an action that would compromise the objective of a directive, in this case the AIFM Directive. Such a compromising action has been expressly precluded by the ECJ very recently, for instance in the *Deister* case, as commented before.

In summary, the authors are of the opinion that, under current Spanish and EU legislation, it is not possible for the Spanish tax authorities to apply the CFC rules to an investment in an EU AIF that is fully covered by the AIFM Directive. Otherwise, there would be a breach of the fundamental freedoms of establishment or, eventually, of the movement of capital.

In addition, the authors' opinion is reinforced by another argument. Spanish legislation has a comparable vehicle to the EU AIF in regulatory terms, the so-called Sociedades de Inversión Libre (SIL). It is possible for a Spanish investor to hold more than 50% of the capital in a Spanish SIL and not only would the CFC rules not apply, but the institution itself would also be taxed at a minimum CIT tax rate of 1%.

The regulatory similarity between the vehicles, and the possibility that, in both cases, an individual investor controls both the EU AIF and the SIL, at least in the sense of the term "control" in the CFC rules, makes it, in the authors' view, more difficult to apply the CFC rules to an EU AIF.

5. The Impact of the ATAD Directive

The question now is whether the application of Directive 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market (the ATAD Directive, not yet transposed into Spanish legislation) could alter the conclusion previously reached.

Article 7 of the ATAD Directive provides for a CFC rule. In many respects, it is similar to the current Spanish CFC rule, so it would be reasonable not to expect too many changes to adapt to the Directive.

In what concerns EU AIFs, the Directive does not include an automatic exclusion of the application of the CFC rule. The Directive provides in article 7.(3) that Member States that opt for the application of option (a) of article 7, section 2 (which is very similar to the current Spanish CFC legislation) *may, in addition, opt not to apply* the CFC rules to financial undertakings if one third or less of the entity's income comes from transactions with the taxpayer or its associated enterprises. The Directive expressly defines AIFs governed by the AIFM Directive as "financial undertakings". Therefore, it is not an automatic exclusion but an option for a Member State, subject to the condition that income obtained by the AIFM must substantially come from transactions with the investor or related parties.

Furthermore, the Directive allows the Member States to opt between two alternative ways of calculating the taxable base when applying the CFC rule (article 7(2) of the ATAD Directive). In section (a) (which is the one currently adopted by Spanish CFC domestic rules, as already commented), it allows the Member State to calculate the taxable base on the basis of computing certain types of undistributed income normally regarded as passive. In section (b), if the Member State opts for it, it will calculate the taxable base exclusively by including undistributed income from non-genuine arrangements put in place for the purpose of obtaining a tax advantage.

If the Member State chooses option (a) (as current Spanish legislation does), the CFC rule will not apply where the CFC "carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances". This general CFC exclusion is compulsory, except in the case that the foreign company is not resident in an EEA country, in which case the Member State may choose whether to apply the CFC rule or not. In any case, it is compulsory for EU-resident companies.

The wording of this automatic exclusion from CFC application, although somewhat similar to the anti-abuse application standard used in the *Cadbury Schweppes* case, is not identical. However, the reason for the existence of such an automatic exclusion rule is very clear: the 12th "Whereas" of the Directive establishes that the aim of this rule is "to comply with the fundamental freedoms".

On the basis of the argumentation put forth in this section, the opinion of the authors is that the ATAD Directive does not change the conclusion as to the illegality of applying the Spanish CFC rules to EU AIFs covered by the AIFM Directive. This opinion rests on the following grounds:

- the legislation that, in the future, will transpose article 7 of the ATAD Directive to Spanish legislation must be analysed, regarding the application of the CFC rules to EU AIFs governed by the AIFM Directive, not only based on the ATAD Directive itself, but also on the EU primary legislation, i.e. the fundamental freedoms. The reason is that there is no exhaustive harmonization given by this Directive concerning the inclusion of AIFs within the scope of the CFC rules foreseen in the ATAD Directive. Therefore, following the ECJ's doctrine, the analysis of any transposing legislation must be made in the light of the fundamental freedoms. A transposition that breaches the fundamental freedoms would be illegal, just as an interpretation of the domestic legislation that breaches these freedoms would be illegal. Therefore, the interpretation standard given by the *Cadbury Schweppes* case, and many others thereafter, will be the one applied in this instance; and
- furthermore, even if Spain decides not to automatically exclude EU AIFs governed by the AIFM Directive from the application of the CFC rule, the AIF would still be excluded if it fell within the general exclusion rule for EU-controlled foreign companies, i.e. if the EU AIF "carries on a substantive economic activity supported by staff, equipment, assets and premises, as evidenced by relevant facts and circumstances". The question is whether this exclusion rule must be interpreted as providing for a stricter standard for applying the *Cadbury Schweppes* anti-abuse application standard (i.e. wholly artificial arrangements, which lack economic reality, aimed at avoiding taxes). In the authors' opinion, the answer should be "no". In other words, the new exclusion rule should be interpreted in the light of the *Cadbury Schweppes* standard, for the following two reasons:
  - the ATAD Directive itself, in "Whereas (12)", provides the reason for the existence of this new exclusion rule, namely to comply with the fundamental freedoms. It does not intend to include a stricter standard than the one already existing when interpreting the possibility to exclude the application of the fundamental freedoms, i.e. the *Cadbury Schweppes* standard; and
  - the authors are of the opinion that the terms of the new exclusion rule do not allow one to say that, on that particular point, the ATAD Directive is bringing about exhaustive harmonization since (i) it only applies if option (a) of article 7(2) of the Directive is chosen by a Member State, not otherwise; (ii) it only applies to cross-border situations; and (iii) its wording, in relevant aspects, is not sufficiently detailed. Therefore, following the ECJ's *Leur Bleum* case doctrine, Member States will have to observe the principle of proportionality to determine the provisions needed to apply the new exclusion rule.

    Since the new exclusion rule does not provide for exhaustive harmonization, the national legislation transposing should be interpreted not only in the light of the ATAD Directive, but also in the light of primary law, i.e. the fundamental freedoms. This leads us back, again, to the *Cadbury Schweppes* standard.

In conclusion, article 7 of the ATAD Directive, regarding the application of the CFC rule to EU AIFs covered by the AIFM Directive, should be interpreted in the light of the anti-abuse doctrine exposed by the ECJ in the *Cadbury Schweppes* case (and many others). Accordingly, once the ATAD Directive is transposed into Spanish legislation (and on the assumption that current legislation substantially remains as it is today), still EU AIFs covered by the AIFM Directive should not be regarded as subject to the CFC rule, at least where transactions with persons different from the investor or related parties constitute more than two thirds of the AIF's income.