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Commentary on the Supreme Court's judgment of 5 April 2023: The Spanish regulations on Non-Resident Income Tax contravene the principle of the free movement of capital by providing for unjustified, differential tax treatments for non-harmonised, non-resident hedge funds or investment funds and resident Collective Investment Institutions

In its judgment of 5 April 2023, the Spanish Supreme Court (SC) held that the Spanish regulation on the taxation of non-resident hedge funds contravenes the principle of the free movement of capital established in Article 63 of the Treaty of the Functioning of the European Union (TFEU) as it establishes unjustified differential tax treatments for resident free investment funds (hedge funds) and non-resident hedge funds in comparable situations. While the Spanish regulation provides for a tax rate of 1% for resident hedge funds, non-resident hedge funds are taxed at 19% on income received in the form of dividends from Spanish companies.

The appellant, a hedge fund based in France, filed a request using Tax Form 210 for the refund of an amount withheld under Spain's Non-Resident Income Tax (NRIT). The amount in question related to a tax on the dividends received from the hedge fund's shareholdings in Spanish-listed companies. The hedge fund sought the refund in circumstances where it considered that the 15% withholding rate established in the Double Taxation Treaty between Spain and France constituted a restriction on the free movement of capital, as similar hedge funds based in Spain were subject to a Corporate Income Tax (CIT) rate of just 1%.

The SC sought to determine whether Spanish tax legislation subjects hedge funds to a different tax treatment depending on their tax residence and, in the event that this different tax treatment exists, whether it violates the principle of the free movement of capital under Article 63 TFEU.

After a thorough analysis of the Spanish legislation in force, the SC held that the Spanish regulation in question discriminates against non-resident hedge funds and that the different tax treatments provided for in Spanish legislation are not justified. Therefore, where a non-resident hedge fund is comparable to a resident hedge fund, the same tax treatment should be applied.

Such comparability analysis must be carried out on the basis of the essential elements considered by the Spanish legislature when granting a more beneficial tax treatment to resident hedge funds. The specific elements to be taken into consideration for the purposes of the comparability analysis are the following:

(i) The funds in question must be open-ended entities, i.e., entities in which retail investors can invest. Therefore, it is not relevant that access is limited to certain professional or qualified investors;

(ii) They must be authorised to operate in their country of origin or residence by the competent authority for the control and supervision of Collective Investment Institutions; and

(iii) They must certify that they are managed by an entity that is authorised to act as an Alternative Investment Fund Manager (AIFM) in their country of origin or residence, under the terms of Directive 2011/61/EU, which harmonises the regime for AIF managers.

The burden of proof of compliance with the above elements will be on the non-resident hedge fund. However, in the absence of a specific regulation establishing the specific proof to be provided, the Spanish Tax Administration cannot require forms of proof that are disproportionate or extraordinarily difficult to obtain. Similarly, if the Spanish

Tax Administration has doubts about the proofs used to verify compliance, it must actively use the powers available under the Double Taxation Treaty or similar conventional instruments signed with the country of origin or residence of the non-resident hedge fund to obtain further information, as well as the mechanisms for the automatic and compulsory exchange of information in matters of taxation in European Union law, in particular, in Council Directive 2011/61/EU of 15 February 2011, on administrative cooperation in the field of taxation.

Nonetheless, the SC has held that the effects of the Spanish legislation's restriction on the free movement of capital can be neutralised if the Double Taxation Treaty allows the tax withheld in Spain to be deducted from the tax due in the other Member State up to the limit of the difference in treatment which the Spanish legislation gives rise to.

In the case in question, and after examining the elements of comparability provided by the non-resident hedge fund, the SC held that the non-resident hedge fund met all the conditions necessary for it to be treated like a resident hedge fund subject to a CIT rate of 1%. In this regard, the hedge fund in question established that:

- It is an open-ended hedge fund, or an alternative investment fund, established in France under French law.
- It has an authorisation for incorporation and operation granted by the competent French authority, the Autorité des Marchés Financiers (AM), the French supervisory body equivalent to the National Securities and Exchange Commission (CNMV).
- It constitutes a separate asset, which raises capital from retail investors, without subjective restrictions unrelated to the degree of professionalism, the knowledge of its investors or a certain minimum investment limit.
- According to certificates issued by the hedge fund's management company, it has more than 100 unitholders, although French law does not impose such a minimum requirement, and its capital in the period under review is more than 3,000,000 euros, although the minimum capital required by French law is not lower.
- It is managed by an entity accredited as an AIFM, which in turn is authorised in its Member state of residence, France, under Directive 2011/61/EU which harmonises the regime for AIF managers.
- Finally, the appellant hedge fund has proven that it is not subject to CIT in France and that it is not possible for it to neutralise the effects of the taxation to which it is subject in Spain on its taxation in its country of residence, France, since it cannot deduct the taxes that it has paid in Spain through the definitive NRIT withholding tax.

Consequently, having proven that it meets all the conditions to be considered comparable to a Spanish resident hedge fund taxed at a CIT rate of 1%, the SC held that the hedge fund was entitled to a refund of the difference between the 1% tax rate that a comparable Spanish resident hedge fund would pay for the same taxable event, and the effective tax rate to which it was subject as a non-resident hedge fund.

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