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New ruling on severance pay for dismissed executives - Pérez-Llorca



In a recent decision by the Spanish High Court, dated 8 March 2017, the court concluded that severances paid for dismissal or termination of senior executive employment relationships could be totally or partially exempt from taxation for personal income tax ("PIT") purposes.

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From a tax perspective, article 7.e) of the Spanish PIT Law, states that, generally under certain circumstances, severances paid for dismissal or termination of employment contracts are exempt, but only up to the mandatory amount foreseen by the labour regulation, whereas severance payments established in an agreement, clause or contract cannot qualify as exempt.

On the contrary, this exemption does not apply when, following the labour legislation, the senior executive is not entitled to receive any amount as severance. However, according to the court's criteria, severance payments received by senior executives as a result of the termination of their special employment relationship, are exempt from PIT with a cap of seven days per year of service, up to a maximum of six months' pay.

The Spanish High Court reaches this conclusion based on a judgement issued by the Spanish Supreme Court dated 22 April 2014. Accordingly, the High Court understands that, pursuant to Royal Decree 1382/1985 governing senior executive employment relationships, severances for senior executive personnel are mandatory up to a minimum of seven days per year of service (with a maximum of six months' pay), even if the parties would have agreed to not receiving compensation of any kind.

According to this criterion, the labour regulation must be deemed to establish that for this kind of relationship, there will be a minimum amount of severance payment even though the senior executive and the employer agree to a lower severance payment. This fact means that, from a tax point of view, such minimum and obligatory compensation is exempt from PIT.

Although this position and interpretation was mostly accepted in the labour field, the Spanish Directorate-General for Taxes ("DGT") recently issued a binding ruling (V1965-15) stating that this minimum amount established in the abovementioned labour regulation is secondary to the agreement made by the parties but not compulsory (taking a literal view of the abovementioned Supreme Court judgement). This interpretation from the DGT implies that severances arising from the termination of the employment relationship of senior executives are subject to, and not exempt from, PIT.

In the absence of a judgment of the Supreme Court (who will take the ultimate decision), taxpayers are therefore faced with two completely different interpretations. Even though in our opinion the interpretation made by the Spanish High Court is the most legal and sound solution, it is worth noting that the view of the DGT rulings bind the tax authorities and therefore, taxpayers could be exposed to a risk in the event that they consider severances received by senior executives to be exempt from taxation.

In our opinion, in order to achieve greater legal certainty (and also greater efficiency of the public resources used by the tax administration during tax procedures or disputes), the Spanish tax authorities should clarify their position as soon as possible (as was the case when the State Tax Agency handed down their view on the late-payment interest deductibility controversy, whether we agree with the decision or not).

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This scenario has added to the recent surge in legal uncertainty created over the last few years, due to, among other factors, a number of tax amendments and Constitutional Court Judgements which have recently annulled certain tax provisions.

Apart from interpretations, as a result of this decision there is an opportunity for taxpayers to request a refund of the undue income from the severance payments received by senior executive personnel in the fiscal years 2012 to 2015. It should be noted that the right to request the corresponding refund of the tax period 2012 will be barred next 30 June 2017, so prompt action should be taken.

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