

# Client Alert

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## European Court of Justice rules that Spanish capital gains tax imposed on non-residents was contrary to EU Law

On 6 October, 2009, the European Court of Justice (ECJ) made public its decision in Case C-562/07 (*Commission v. Spain*), in which the ECJ ruled that a provision of the Spanish Nonresidents' Income Tax Act (which was derogated in 1 January 2007) was contrary to the freedom of movement of capital set forth under the EU Treaty and under the Agreement on the European Economic Area (EEA).

The provision that was ruled contrary to the EU/EEA principles provided for the taxation of capital gains obtained by nonresidents at a 35 percent flat rate. At that time, however, capital gains obtained by Spanish tax-resident individuals were taxed as follows: long-term capital gains (*i.e.*, capital gains triggered upon the disposal of assets held for a period of more than one year) were taxed at a 15 percent flat rate. Short-term capital gains, on the other hand, were taxed according to a progressive scale, with rates ranging from 15 percent to 45 percent. For a nonresident individual, the only possibility of being taxed under the rules applicable to Spanish residents would occur in cases where at least 75 percent of such nonresident's total income in a given year was derived from employment or economic activities in Spain (provided that a proper election was filed).

In the view of the European Commission, this set of rules could be deemed to be discriminatory to certain nonresidents who were in the same position as Spanish residents. For instance, a nonresident individual obtaining a long-term Spanish source capital gains could be taxed at a 35 percent rate, whereas a Spanish-resident individual could be taxed at a 15 percent rate. In respect of short-term capital gains, the only situation in which a Spanish-resident individual obtaining short-term capital gains would be more heavily taxed (in comparison with a nonresident taxpayer) would take place in situations where such resident taxpayer's average tax rate would exceed 35 percent (which, in the view of the Commission, would only happen in cases where the level of income obtained by such taxpayer was "very substantial", which would occur in very few cases).

In 2006, Spain committed to repeal this scheme, which has been in place for several years, as from 1 January 2007 (afterwards, capital gains obtained by both nonresidents and resident individuals would be generally taxed at an 18 percent flat rate); however, the Spanish government has not acknowledged that the prior rules were contrary to

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EU law, and the Commission decided to bring action before the ECJ against Spain.

Spain defended its case before the ECJ by arguing the following arguments regarding the substance of the matter: (a) the situation of resident taxpayers and nonresident ones is not comparable in relation to the taxation of capital gains (in order to compare their situation, it would be necessary to take an overall view of their tax situation as a whole, and not rely only on one single kind of transaction); and (b) Spain had tax treaties in force with most Member States, under which the taxation of Spanish-source capital gains was alleviated. Alternatively, Spain also tried to argue that if a restriction to the free movement of capital existed, it was justified by the need to safeguard the cohesion of its tax system (*i.e.*, the existence of different tax rates was justified due to the impossibility of tax nonresidents according to a progressive scale).

The ECJ found that Spain's arguments could not be accepted. According to the ECJ, although it could not be stated that resident taxpayers were not systematically entitled to a more favourable rate than nonresidents in connection with short-term capital gains, in practice, this is what happened in most cases, given Spain's progressive tax scale. In respect of long-term capital gains, the applicability of the 35 percent tax rate to nonresidents was discriminatory in any case. Moreover, the ECJ noted that tax treaties between Spain and the EU/EEA Member States do not provide for an elimination of capital gains taxation in Spain; rather, they merely cancel out the tax liability of nonresidents in a partial manner. Similarly, the ECJ dismissed Spain's arguments in respect of the cohesion of its tax system, as the applicability of the 15 percent flat rate to Spanish-resident individuals was not progressive either. Consequently, the Spanish pre-2007 scheme of taxation of capital gains obtained by nonresident individuals was contrary to EU/ EEA principles.

Given the outcome of this case, individual taxpayers resident in EU/ EEA Member States that have paid Spanish nonresidents' income tax at a 35 percent as a consequence of the rules applicable before 1 January 2007 (for instance, individuals who were not entitled to a tax exemption pursuant to the Spanish domestic rules or to a tax treaty provision) should now explore the options available to claim a tax refund from the Spanish Tax Authorities. In particular, nonresidents who have sold in the past real estate property located in Spain (such capital gains are generally not exempt under the tax treaties signed by Spain) may be entitled to recover a substantial portion of the capital gains taxes paid back then.

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