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Spain

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Spanish Supreme Court rules on Swiss company permanent establishment

The case concerns a Swiss pharmaceutical company and its Spanish subsidiary. Until 1999, the Spanish company manufactured, imported and distributed the pharmaceutical products for the Spanish and Portuguese markets as a full risk business.

Starting on August 1, 1999 and following a restructuring of the business to reduce costs, the Swiss parent and its Spanish subsidiary concluded two separate and distinct contracts:

- A contract manufacturing agreement, under which the Spanish company would manufacture and pack the products following the Swiss principal's instructions. The Spanish company was remunerated on a cost-plus basis.

  In addition, the Swiss company rented warehouse space from the Spanish subsidiary to store the products manufactured under contract until they were sold.

- Under the second contract, the Spanish subsidiary was appointed as "agent" of the Swiss company for the Spanish market to promote the sale of certain products specified in the agreement, and to "represent, protect and foster"

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the Swiss company's interests in return for a commission fee of 2% of the Spanish sales.

The Swiss company sold the products and fixed the prices; the Spanish agent was not authorized to negotiate contracts on behalf of the Swiss entity, although it was authorized to process purchase orders. As a consequence of the restructuring, the Spanish subsidiary's profits were considerably lower than those of a full-fledged manufacturer / distributor.

The Spanish tax authorities audited the income years 1999 and 2000 and concluded that the Swiss company carried on its business in Spain through a permanent establishment ("PE"). The Spanish tax authorities claimed that given the two contracts mentioned above, the Swiss principal was carrying out an economic activity in Spain through a fixed place of business.

The Court's decision

The Central Tax Court confirmed the tax authorities' assessment and the National High Court later upheld it in 2008.

Interestingly, the National High Court reasoned that the Swiss company was not deemed to have a fixed place of business PE, as the activities carried out from the warehouse were auxiliary in nature.

The High Court also stated that the sales promotion contract alone could not create a dependent agent PE. However, when examined in conjunction with the manufacturing contract, it concluded that the Spanish company was a dependent agent of the Swiss principal. The Spanish company limited itself to manufacturing products following the strict instructions from Switzerland and the Swiss principal fully bore the business risk. The High Court reasoned that the Spanish company was acting as an "employee" of the Swiss "entrepreneur" and thus should be viewed as dependent on the Swiss company. The High Court argued that the dependent agent clause in the Swiss-Spanish treaty (and in the OECD Model Treaty) should be interpreted broadly and applied not only to situations where the agent has authority to conclude agreements binding on the principal, but also when, regarding the nature of its activity, the agent is involved in the business activities of the national market.

The judgment infers that the Spanish company was a dependent agent of the Swiss company based on the combination of the following three factors. The Spanish company:

i) was manufacturing under contract,

ii) was remunerated based on its costs plus a mark-up, and

iii) had only one client (the Swiss company).

The 2008 National High Court's decision was heavily debated, particularly the novel notion –at least in Spanish case law– of a "manufacturing dependent agent."

The Supreme Court refers to the decisions of both the National High Court and the Central Tax Court (which reached the same conclusion but on the basis of the fixed place of business PE provisions) and rejects the appeal. Unfortunately, the Court's decision does not indicate whether the Supreme Court agreed with the reasoning of the Central Tax Court, the National High Court, or both.

Also, the Supreme Court confirms the National High Court's view that, once a PE is deemed to exist because of the manufacturing activities, the PE's profit includes the profit attributable to the manufacturing activity and also the profit obtained on product sales. The Court reached this conclusion based on paragraph 34 of the OECD Model Tax Treaty Commentary.[1]

Finally, the Court upheld the lower court's view that remuneration of the manufacturing activities based on the Spanish entity's internal costs is not an arm´s length method. This suggests that, in the Court's view, the PE analysis overrides Spanish and OECD transfer pricing guidelines.

PE decisions are very much facts-and-circumstances-driven and it is therefore difficult to extract generally applicable conclusions from this Spanish Supreme Court decision, particularly given the broad interpretation of the dependent agent clause in the tax treaty.

Note that in the Spanish legal system a Supreme Court's isolated decision does not constitute a precedent binding on lower courts. This notwithstanding, taxpayers should monitor the Supreme Court's future decisions on PE issues. Multinational groups with similar structures in place in Spain should assess their specific situation against this case's facts and consider any potential impacts.

The Court's decision highlights the need to document transfer pricing policies and arm´s length remuneration of intragroup transactions to address potential tax authority PE challenges in the context of business restructurings.

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[1] "Where the requirements set out in paragraph 5 are met, a permanent establishment of the enterprise exists to the extent that the person acts for the latter, i.e., not only to the extent that such person exercises the authority to conclude contracts in the name of the enterprise."