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Main tax issues in the purchase of debt and subsequent debt restructuring: Spain's 2015 update

Sales of under-performing or non-core loan portfolios by Spanish and non-Spanish financial institutions, and also by Spanish "bad bank" SAREB, are expected to continue during 2015, due to the deleveraging process caused by regulatory requirements and increased focus on profitability, and to the reduction in sell/buy price expectations gap. This provides an opportunity for overseas buyers to purchase distressed loans of Spanish entities at significant discounts.

Taxes may have a significant impact in the return of these investments, and in this note we summarize some of the main Spanish tax issues that should be considered both in the purchase of debt and also in the subsequent restructuring of such debt, taking into account the significant tax amendments approved during 2014 and the Spain's tax reform that came into force in 2015.

We include also some brief comments on the tax treatment of so-called FABs ("Fondos de Activos Bancarios"), which are special funds designed to facilitate the disposal of assets by the Spanish bad bank SAREB.

1. TAX ISSUES IN THE PURCHASE OF DEBT

1.1 Stamp duty in the purchase of mortgage debt

Public deeds executing the transfer of mortgage debt are subject to Stamp Duty at rates ranging between 0.5% - 2% on the secured amount. This Stamp Duty is payable by the buyer pursuant to the law.

Certain alternatives could be considered to mitigate or postpone the impact of Stamp Duty (i.e. Law 2/1994 exemption if the seller and the buyer are financial entities and certain requirements are met, sub-participation agreements, etc.).

1.2 Spanish Income tax implications for the Buyer

From an Income tax perspective, an appropriate investment structure should take into account both the potential Spanish withholding tax on the Spanish-source yield on the acquired debt, and the corporate income tax on the yields obtained in the jurisdiction of the special purpose vehicle acquiring the debt (**SPV** or **Buyer**).

Spanish withholding tax: Available exemptions

From a Spanish withholding tax perspective, both (i) the interest income accrued on the debt principal and (ii) the gain obtained for the difference between the debt principal collected and the purchase price paid for the debt (which is also characterised as "interest income" for Spanish tax purposes) are taxable in Spain under Spanish domestic legislation, at a 20% flat rate in 2015, which will be reduced to 19% in 2016 onwards.

Non-resident investors obtaining Spanish-source income are taxed on an income-by-income basis, not being possible as a general rule to offset interest income with losses.

Spanish domestic tax legislation provides for a withholding tax exemption on interest income when the Buyer is resident in a EU jurisdiction[1], provided that the Buyer can obtain a certificate of tax residence issued by its country of residence and it does not obtain the interest income through a permanent establishment in Spain nor through a territory included in the tax haven list published by the Spanish Tax Authorities.

In this respect, the Buyer would be deemed to have a permanent establishment in Spain if it has an office or employees in Spain, or if the Spanish local servicer acting on behalf of the Buyer to manage the loan portfolio is not independent from the Buyer.

This domestic exemption does not expressly include a "beneficial owner" clause, but Spanish Tax Authorities

[1] Besides, some tax treaties entered into by Spain provide for a 0% withholding tax on interest, such as the tax treaties with Switzerland or with UAE, or the protocol amending the Spain-US tax treaty, not yet into force.

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are entitled to apply Spanish general anti-avoidance tax rules and "look-through" the Buyer to identify the ultimate investor (i.e. similar to a "beneficial owner" clause) if the SPV structure has a lack of economic or legal substance and is set up only for tax reasons.

Tax status of the Buyer/SPV

As a general rule, the Buyer would be subject to corporate income tax in its jurisdiction for the difference between (i) the yield obtained on the distressed debt acquired, which accrues on the face value, and (ii) the yield payable on the debt borrowed (if any) to fund the purchase price.

Jurisdictions which are "usual suspects" to locate the investment vehicles to purchase debt in Spain are mainly Luxembourg, Ireland and The Netherlands, where the corporate income tax impact could be mitigated as follows:

(a) By setting up the SPV as a "tax exempt" vehicle (e.g. Qualifying Investor Funds or "QIFs" in Ireland, SIF or SICAR vehicles in Luxembourg); or

(b) By having a "taxable" vehicle (i.e. Soparfi or Securitization company in Luxembourg, Section 110 companies in Ireland, or Dutch BVs) but where the interest income is almost fully offset with tax deductible distributions structured through profit participating loans, asset-linked loans, or hybrid loans (e.g. PECs).

In this regard, from a Spanish tax perspective we can envisage two scenarios:

1. The SPV is tax exempt in its jurisdiction: In this case we should confirm whether it would nevertheless qualify as tax resident in its jurisdiction for the purpose of benefitting from the Spanish withholding tax exemption; or

2. The SPV is taxable in its jurisdiction: Here we should check whether the Spanish withholding tax exemption could be challenged under Spanish general anti-avoidance rules, if most of SPV's taxable income is passed on to the investors through tax-deductible financial instruments.

Furthermore, attention should be paid to the development of current international initiatives against aggressive tax planning (e.g. OECD's Base Erosion Profit Shifting project –BEPS– and EU Commission recommendation addressing aggressive tax planning), and how Spain and other jurisdictions implement such recommendations.

"Substance" of the SPV structure

We anticipate that the investigations opened by the European Commission against tax ruling practices in several EU jurisdictions would likely result in more transparency and exchange of information amongst the EU countries.

In this context, it is likely that the Spanish Tax Authorities will look at these SPV structures with a closer scrutiny under Spanish anti-avoidance tax rules, and Buyers should be able to justify that the SPV is effectively managed from its jurisdiction, and that there are valid legal, financial or commercial reasons to purchase the debt through the SPV.

In our view, this environment will make that investment structures with EU SPVs should be more carefully implemented.

1.3 VAT implications

The transfer of loans or credit rights is exempt from Spanish VAT. However it is important to check whether the VAT exemption covers all the services to be rendered within the transaction.

Fees from the debt servicer charged to the SPV should not be subject to Spanish VAT if the SPV obtains a VAT number in its jurisdiction, unless the debt servicer takes the view that its services are connected with immovable property located in Spain (i.e. if the service includes advice on the underlying real estate in mortgage loans).

2. TAX ISSUES IN DEBT RESTRUCTURINGS

2.1 Amendment of the debt's terms & conditions

If this amendment is deemed a "substantial" modification of the existing debt as defined for Spanish GAAP purposes (i.e. because the recalculated net present value of the new cash flows estimate differs more than 10% of the existing carrying amount), the debtor would de-recognise the existing debt and a new debt would be recorded at fair value. The difference

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between the two values would be recognized in the P&L account, included in the debtor's taxable income.

In this regard, particularly when senior debt is converted into subordinated debt such as profit participating loans (PPLs), a careful analysis should be made to check how the subordination element and the participating interest component could affect the cash flow estimation.

This taxable income could be offset with:

(a) Tax losses of the current year, taking into account that some accounting expenses/losses are not tax deductible (i.e. financial expenses are deductible up to the limit of 30% EBITDA, and portfolio/assets accounting impairments are no longer deductible); or with

(b) Carryforward tax losses from previous years. However, during 2015, these can only offset up to 25%/50% of the taxable income (which could result in tax leakage) provided that the debtor's turnover in the previous year has exceeded € 20 million. In 2016 onwards, the New CIT Law provides that carryforward tax losses can offset 70%[2] of the annual positive taxable income, irrespective of the turnover of the company. In any case, carryforward tax losses up to €1 million can be used without limitation.

2.2 Debt-for-equity swap

Conversions of debt into equity could trigger accounting income at the debtor where the fair value of the debt is lower than its nominal value, because such difference should be recognized as income in the P&L account (following the criteria of the ICAC, the Spanish accounting authority), and this accounting income would be, in principle, taxable.

However, the tax impact of the above described accounting treatment has been mitigated by recent changes in tax legislation, which give much more flexibility in refinancing processes to cancel existing shareholders or third party debt in order to strengthen the borrower's net equity.

Specifically, since 1 January 2014[3], capitalizations of debt into equity would not imply a taxable event for CIT purposes for the debtor (regardless of its accounting treatment), but it would be treated for tax purposes as a shareholder's equity contribution (non-taxable for the debtor).

However, if the debt has been previously acquired by the creditor at a discount on its nominal value, the creditor would be deemed to obtain a taxable income for the difference between the equity increase (proportionally to its participation) and its tax base cost in the debt that is converted.

Such income would be exempt if the creditor is resident in a EU jurisdiction, subject to the comments described in section 1.2 above, but if the creditor is a Spanish tax resident, and does not sell the shares received in the borrower in the same tax period as the capitalization, the conversion of shareholder's debt could generate a cash tax impact for the creditor, since it would recognise a taxable income in the year in which the debt is converted into equity, but the subsequent loss (as a consequence of the increase of the tax base cost in the borrower's shares due to the capitalization) would not be recognised until the year when the shares are transferred.

2.3 Partial waiver of the debt

The partial waiver of the debt would trigger accounting income in the debtor's P&L account, unless the creditor is the 100% shareholder of the borrower (in this case it would treated as shareholder's equity contribution), and this accounting income would be, in principle, taxable, subject to the comments below:

(a) **Full relief by carryforward tax losses**

Pursuant to a recent tax amendment included in the Spanish tax reform, as from 2016 onwards it would be possible to use carryforward tax losses to fully offset the taxable income derived from debt waivers resulting from an agreement with creditors, "related" or "non-related".

In 2015 this full relief will be also applicable, but limited to debt waivers resulting from an agreement

[2] In 2016, the percentage will be 60% pursuant a transitory regime

[3] Introduced by Royal Decree-Law 4/2014 on urgent matters in relation to refinancing agreements and debt restructuring ("**RDL 4/2014**")

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with creditors that are "non-related" with the taxpayer. In this regard we note that, as of 1 January 2015, a creditor owning a shareholding in the borrower shall be regarded as a related party to the borrower when it holds a shareholding of at least 25% (previously the threshold was 5% as a general rule, and 1% when the borrower is a listed entity).

This recent amendment would avoid triggering cash tax impact in circumstances where the accounting income derived from the debt waiver cannot be fully offset with tax losses of the current period (i.e. because the assets impairments were recognized in previous years, or due to the recent restrictions to take a full tax deduction for financial expenses or for portfolio/assets accounting impairments), and thus the strict application of the general limitation to use carryforward tax losses would had led to the paradox of insolvent companies incurring income tax liabilities.

(b) **Special case: Tax deferral of income derived from debt stays or write-offs**

Since 1 January 2014[4], income recognized for accounting purposes by the debtor in debt stays or write-offs resulting from the application of the Insolvency Law shall be deferred for CIT purposes and included in the debtor's CIT taxable base over the tax periods when the remaining debt accrues financial expenses.

This tax deferral shall also be applicable in order to determine the accounting result which is taken into account to calculate the minimum CIT prepayment of 12% of the accounting result due for companies whose turnover in the previous tax period has exceeded € 20 million.

2.4 Debt-for-asset swap

Tax implications for the borrower

From a corporate tax perspective, a debt for asset swap may trigger taxable income for the debtor either as a taxable gain on the asset transfer (i.e. if the fair value of the asset is higher than its tax base cost) or as a debt waiver (if the fair value of the asset is lower than the outstanding amount of the debt that is cancelled).

Depending on the circumstances of the debt for asset swap, we understand that the exception to the limitation to use carryforward tax losses described in section 2.3 above should also apply to the income derived from the debt waiver, but so far the Spanish tax Authorities have not provided further guidance.

Tax implications for the Buyer

The potential gain derived from the difference between the tax base cost in the debt and the fair value of the asset received shall be exempt in Spain if the creditor is tax resident in the EU (as exempt interest income).

If the creditor is a Spanish SPV (to which the debt has been previously transferred by the Buyer), in our view this Spanish SPV should not recognize any taxable income as long as the acquisition of the asset does not trigger accounting income (but only when it subsequently transfers the asset at a gain), although we note that this tax treatment is controversial.

From an indirect tax perspective (in case of real estate assets), attention should be paid to non-recoverable indirect taxes such as Transfer Tax (especially in the case of residential property, if the VAT exemption cannot be waived) or Stamp Duty.

Depending on the type of asset it may be possible to structure the debt for asset swap as subject to VAT (in which case only Stamp Duty would be due, but not Transfer Tax). Furthermore, in certain circumstances the VAT reverse-charge mechanism would apply, in which case the acquirer would have to self-assess the VAT without a VAT cash payment being due.

Municipal tax on the increase in value of urban land

Last but not least, the municipal tax on the deemed increase in value of urban land should be considered. If the debtor has held the property for a long period of time this tax could be very relevant (as it is calculated by applying certain coefficients to the cadastral value of the land, ignoring its market value).

This tax is borne, by law, by the transferor of the land, but could affect the creditors as long as the borrower does not have the cash to pay this tax.

[4] Introduced by RDL 4/2014

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However we note that some Regional courts are rejecting the application of this tax on the basis that there has not been a real increase in the fair value of the land.

2.5 Debt buy-back

If a debtor buys back its debt at a discounted price, it should recognize the difference between the nominal value and the purchase price as an accounting income in its P&L account, which would be taxable. However, in our view, the borrower should be able to offset this taxable gain with carryforward tax losses without limit, as in the case of a debt waiver (see section 2.3 a) above).

Debt buy-backs are often structured as a purchase of debt by the borrower's parent company, which keeps in place the (now intra-group) debt with the borrower in order to avoid triggering accounting and taxable income at the borrower.

3. BRIEF COMMENTS ABOUT SAREB's "FABs"

Investors could consider investing in assets or loans currently owned by the SAREB by acquiring securities issued by the so-called "FABs" or "Banking Asset Funds", which are investment funds without separate legal personality, similar to securitization funds, specifically designed to facilitate SAREB's[5] divestment process (FABs can only be set up by SAREB).

FABs are supervised by the CNMV, are managed by registered FABs management companies, and the securities issued by the FABs can only be subscribed or acquired by professional or institutional investors. SAREB should keep a minimum 5% interest in the FAB in order for the FAB to benefit from the special tax regime described below.

FABs are subject to Spanish corporate income tax at a 1% rate (as other Spanish regulated investment funds), and investors in FAB's securities are exempt from Spanish withholding tax. This would allow investors to obtain the return free from Spanish withholding tax without the "substance concern" discussed in section 1.2 above for EU SPV structures.

FABs do not inherit tax liabilities of SAREB or previous owners on the assets/loans acquired, and can have several sub-funds to enable the ring-fencing of the sub-funds' assets and liabilities.

From an indirect tax perspective, FABs are exempt from Transfer tax or Stamp Duty in acquisitions of assets/loans from SAREB (this is particularly relevant in the acquisition of residential property subject to 7-10% Transfer Tax). However, subsequent acquisitions of assets from borrowers in debt-for-asset swaps would not be covered by this exemption.

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[5] The first sale of a REO portfolio by SAREB in August 2013 was structured through a FAB. It is expected that SAREB will have six FABs in place by the beginning of 2015.

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