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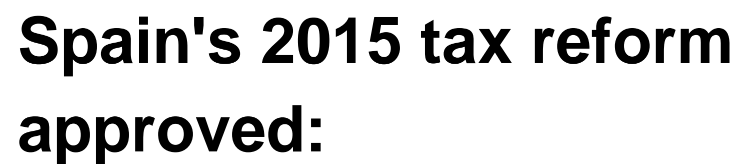

Spain's 2015 tax reform approved:

What foreign investors and M&A players should know

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The Spanish Parliament has finally approved the bills proposed by the Spanish Government which include significant amendments to Spanish Corporate Income Tax ("**CIT**"), Personal Income Tax ("**PIT**") Law, and also minor changes with respect to VAT and taxation of non-residents (the "**Tax Reform**").

The Tax Reform includes the following bills:

- Law 26/2014, which amends Spanish PIT Law and Spanish Non-residents' Income Tax Law
- Law 27/2014, which approves a new Spanish CIT Law (the "**New CIT Law**"), and
- Law 28/2014, which amends Spanish VAT Law and other tax laws.

The bills were published in the Spanish Official Gazette on 28 November 2014, and will come into force as of 1 January 2015.

The Tax Reform will impact the Spanish tax position of sellers and buyers in M&A transactions, and the tax cash flow projections of Spanish entities, as discussed below.

In this note we summarize the main tax changes that, in our view, should be taken into account by M&A players and foreign investors planning to invest in Spain or with existing investments in Spanish entities.

1. Tax deduction of acquisition debt: Additional restrictions

Currently, Spanish CIT Law provides that net financial expenses (that is, the excess of financial expenses over interest income), either with *related or unrelated* lenders, shall be tax deductible up to a limit of 30% of the EBITDA (as defined in this tax provision) of the tax period. Net financial expenses exceeding this 30% EBITDA limit can be carried-forward and deducted in the following 18 years (subject to the same 30% EBITDA limit). If the entity forms part of a Spanish tax group, the limit shall be applicable at the level of the tax group (certain particular rules are applicable for companies joining and leaving the tax group).

1.1 New "anti-LBOs" tax provision

The New CIT Law keeps this 30% EBITDA deductibility limit, but includes an additional limitation for *leveraged buy-out* (LBO) transactions restricting the tax deductibility of acquisition debt against the taxable profits of the acquired target entities through tax consolidation or a merger (being an "anti-LBO" tax provision).

In particular, this new provision states that, when calculating the 30% EBITDA limit to deduct the interest accrued by a Spanish BidCo on the debt borrowed to acquire the target entities, the EBITDA of the target entities that have joined the BidCo´s tax group or that have been merged into BidCo should be excluded.

Also, in order to prevent increasing the EBITDA of the Spanish BidCo with further acquisitions, the New CIT Law provides that it should also be excluded the EBITDA of any other entity that joins BidCo's tax group or is merged into BidCo in the four years after the LBO acquisition.

However, this additional limitation shall not apply if (i) the amount of the purchase price financed with debt does not exceed 70% of the total purchase price, and (ii) in the eight (8) fiscal years following the acquisition the borrower repays debt principal every year, at least in an amount of 1/8 each year of the amount of principal to be repaid until the debt principal is reduced to 30% of the initial purchase price.

The New CIT Law provides that this anti-LBO provision shall not apply to acquisitions where the target entities have joined the BidCo's tax group in tax periods commencing before 20 June 2014, or where the target entities have been merged into BidCo before 20 June 2014. Also, this limitation would not apply when the merger takes place after 20 June 2014 but the target entities already belonged to the BidCo's tax group in a tax period commencing before 20 June 2014.

This "anti-LBO" tax provision will certainly have an impact in the structuring of acquisition debt. If the acquisition debt falls within its scope (for example, bullet debt), buyers may need to consider strategies to push down debt to the target entities, although they should take into account the potential application of anti-avoidance tax rules preventing the tax deductibility of refinancing debt (we refer to Spanish Tax Authorities' and National Court's position in the "Dorna dividend recap" case and in debt financing of share buy-backs).

Also, this change may make it advisable to structure subsequent "add-on" or "build-up" acquisitions through operating subsidiaries with strong EBITDA, and not through the group holding company.

1.2 Restrictions to tax deductibility of hybrid financial instruments

The New CIT Law also includes changes with respect to the tax deductibility of certain hybrid financial instruments:

a) The return accrued on hybrid financial instruments representing share capital or equity of the issuer (for example, **non-voting shares, redeemable shares**) shall be characterized as a dividend for CIT

purposes of the issuer (and therefore non-tax deductible), regardless of its characterization for accounting purposes

b) Interest accrued on **profit participating loans**, when the lender and the borrower form part of the same accounting group, shall be characterized as a dividend for CIT purposes (and therefore non-tax deductible), regardless of the tax residency of the lender. This tax change shall not apply to participating loans granted before 20 June 2014, and

c) Interest accrued on **financial instruments with related parties** shall not be tax deductible for the Spanish borrower if this interest is characterized as a dividend in the lender's jurisdiction, and as a consequence of this tax characterization in the lender's jurisdiction the income is tax exempt or subject to a nominal tax rate below 10%.

2. Reduction of tax rates

2.1 Reduction of CIT rate

- Existing standard 30% CIT rate for Spanish entities shall be reduced to 28% in 2015 and to **25% in 2016**.
- However, credit entities and entities engaging in exploration and exploitation of hydrocarbons shall be subject to 30% CIT rate.

2.2 Reduction of withholding tax rates

- Existing standard 21% withholding tax rate on dividends and interest shall be reduced to 20% in 2015 and to 19% in 2016.

3. Spanish entities can be exempt on "domestic" gains from Spanish shareholdings

Currently, Spanish entities are taxed on capital gains derived from Spanish shareholdings (except for the part of the gain corresponding to undistributed earnings generated during the holding period), which makes foreign investors structure their exit strategies typically through Luxembourg or Netherlands holding companies, in order to benefit from the capital gains exemption provided in the double tax treaties signed with Spain.

The New CIT Law introduces an exemption to capital gains from Spanish shareholdings, under the same participation exemption regime applicable to non-Spanish shareholdings, with certain specialties.

We understand that this new exemption would give foreign investors more flexibility to structure their exit strategies, although the requirements to distribute dividends out of Spain (after an exit) without withholding tax should be carefully analysed (for example, the withholding tax exemption applicable to EU resident shareholders does not apply to distributions derived from the liquidation of the Spanish subsidiary).

Also, we note that **this new exemption creates a significant difference in the tax treatment of share deals versus asset deals** (which remain taxable), and thus we anticipate an increase of pre-sale reorganizations to prepare a share deal (although we note that the exemption would not apply if the shares have been received in exchange for a contribution of assets, other than shares, implemented under the tax neutrality regime), and a higher impact of the tax input in the purchase price offered depending on the deal structure (because share deals will no longer allow the purchaser to deduct the embedded goodwill paid, as explained below).

We summarize below the main requirements to benefit from the capital gains exemption:

a) **Shareholding threshold:** The Spanish shareholder entity should have a direct or indirect shareholding in the capital or equity of the Spanish subsidiary of at least 5% or, failing this, an acquisition value of at least €20 million

b) **Additional requirement for indirect shareholdings held through a "holding company":** When more than 70% of the income of the Spanish subsidiary derives from dividends and capital gains from shareholdings (if the subsidiary is the parent of a consolidated accounting group, the computation should be made taking the consolidated income of the accounting group), the Spanish shareholder should have an indirect 5% participation in those second and lower-tier shareholdings, except if those second and lower-tier entities form part of the same accounting group of the first-tier subsidiary. There are special rules to prevent double taxation in case of a chain of holding companies

c) **"Business activity" test:** The New CIT Law does not expressly require the Spanish subsidiary to carry on a "business activity", but the following capital gains would not qualify for the exemption[1]:

[1] There are special rules if this test is met only in some fiscal years

i. Capital gains derived from shares in a "passive" holding company ("*entidad patrimonial*"), as defined in the Spanish CIT Law (that is, an entity where more than 50% of its assets consist of assets not connected with a business activity, or passive shareholdings, as defined), and

ii. Capital gains derived from shares in CFC entities, as defined in the Spanish CIT Law (international tax transparency rules), where 15% or more of its income qualifies as passive income for CFC purposes (see below our comments on the amendments to the definition of CFC passive income).

However, the New CIT Law expressly states that the "substance" required to meet the business activity test shall be measured at a "group level", as opposed to as a "single-entity" level, which facilitates significantly the fulfilment of this requirement.

d) **No "subject-to-tax" test:** The New CIT Law does not require the Spanish subsidiary to be subject to a minimum taxation, as this is only required in the case of non-Spanish shareholdings[2]. However, we note that this test would be relevant if the Spanish first-tier subsidiary owns non-Spanish shareholdings (that is, if the lower-tier foreign subsidiaries do not meet this test, the portion of the capital gain attributable to unrealized reserves of the Spanish subsidiary that can be allocated to those underlying foreign shareholdings would not benefit from the exemption).

4. Taxation of "domestic" dividends: Relevant changes

The existing credit method applicable to domestic dividends is replaced by a participation exemption regime, with the same shareholding requirements as described above in the participation exemption applicable to domestic capital gains (for example, minimum 5% shareholding, directly or indirectly, or acquisition value of at least €20 million).

However, we note that **in some situations the application of the participation exemption may be less beneficial than the existing dividend tax credit**:

a) Shareholdings below 5% would no longer benefit from the 50% dividend tax credit, although could be 100% exempt if the €20 million acquisition value threshold is met

b) New requirement to calculate **indirect shareholdings** when the Spanish subsidiary distributing the dividend qualifies as a holding company, as above defined. For example, Spanish entities investing in 5% shareholdings in investment vehicles may no longer benefit from full dividend relief if the investment vehicle invests in minority (non-group) shareholdings

c) If the Spanish subsidiary owns non-Spanish shareholdings, these indirect foreign shareholdings should meet the "subject to tax" test (otherwise the portion of the dividend distributed by the Spanish subsidiary that is paid out of dividends and gains from those foreign shareholdings would not benefit from the exemption), and

d) When the buyer of the shares receives a dividend post-closing, now he **could not get a double tax relief for the capital gains tax paid by the seller** of the shares paying the dividend, as explained below.

Current Spanish CIT Law allows a Spanish corporate shareholder (Buyer) receiving a dividend from a Spanish company (Target) to recognize a dividend tax credit on account of Spanish tax paid by the Seller of the Target's shares, on the basis that the dividend distributed is paid out of the Target's profits crystallizing the goodwill on which the Seller has paid capital gains tax.

However, the New CIT Law no longer foresees the possibility of taking this dividend tax credit, arguing that capital gains obtained by Spanish sellers on the disposal of shares in Spanish entities shall no longer be taxable, and thus there is no double taxation to be mitigated (there is a transitional provision for dividends paid by shares acquired before 31 December 2014 if the seller of the shares had paid capital gains tax).

However we note that this new dividend exemption, compared with the existing dividend tax credit, would result in double taxation when (i) the Seller of the Target shares is taxed because he does not meet the requirements for the capital gains exemption, (ii) the Seller is a Spanish individual (which remain taxable on capital gains, as described below), or (iii) the Seller is non-Spanish resident and is taxed in Spain on such gain in application of the relevant double tax treaty with Spain.

[2] The foreign entity should be subject to a nominal rate of at least 10%, although this requirement is deemed to be met if the foreign entity is resident in a jurisdiction with a tax treaty with Spain including an exchange of information clause

Also, the **New CIT Law includes special rules for hybrid instruments and equity derivatives**:

- Interest on hybrid financial instruments representing share capital of the issuer (for example, non-voting shares, redeemable shares), and interest on profit participating loans granted to group entities[3] shall be characterized as dividends and could benefit from participation exemption, and
- The New CIT Law provides a special rule for derivatives when the legal holder of the shares is not the beneficial owner of the dividend, such as stock loans or equity swaps. In these cases, the exemption is granted to the entity that economically receives the dividend (through a manufactured dividend or compensation payment), and not to the formal holder of the shares, provided that certain conditions are met (for example, accounting recognition of the shares).

5. Spanish entities owning foreign subsidiaries: Relevant changes in participation exemption (dividends and capital gains) and CFC rules

5.1 Exemption on dividends and gains from non-Spanish shareholdings

The New CIT Law introduces several amendments to the existing participation exemption on non-Spanish shareholdings. Foreign investors owning Spanish companies with foreign subsidiaries should review the new requirements to check if they can still benefit from participation exemption.

a) **Shareholding threshold:** Existing participation exemption regime requires a direct or indirect shareholding in the capital or equity of the non-Spanish entity of at least 5%. Moreover, if the Spanish entity has elected for the ETVE (that is, Spanish holding company) tax regime, this shareholding threshold would also be met if the acquisition value is equal to, or greater than, €6 million.

   The New CIT Law keeps the ≥5% shareholding requirement, but adds to the general participation exemption regime the acquisition value threshold as an alternative when this 5% shareholding is not met, even if the Spanish entity is not an ETVE, although this threshold is increased to €20 million (this also applies to ETVEs[4]).

b) **Additional requirement for indirect shareholdings held through a "holding company"**: When more than 70% of the income of the non-Spanish subsidiary derives from dividends and capital gains from shareholdings (if the subsidiary is the parent of a consolidated accounting group, the computation should be made taking the consolidated income of the accounting group), the Spanish shareholder should have an indirect 5% shareholding in those second and lower-tier shareholdings, except if those second and lower-tier entities form part of the same accounting group of the first-tier subsidiary (this is similar to the existing rule for ETVEs, which is now applied also to non-ETVEs). There are special rules to prevent double taxation in case of a chain of holding companies.

c) "**Business activity" test**: The New CIT Law removes the "business activity test" of the non-Spanish entity in order to benefit from participation exemption on dividends[5].

   However, the New CIT Law keeps this requirement in order to benefit from the exemption on capital gains. Specifically, capital gains derived from shares in "passive" holding companies, as defined in the Spanish CIT Act, and from shares in companies where 15% or more of its income qualifies as CFC passive income, as defined in the Spanish CIT Act, would not qualify for the exemption. However, the New CIT Law expressly states that the "substance" required to meet the business activity test shall be measured at a "group level", as opposed to at a "single-entity" level, which facilitates significantly the fulfillment of this requirement.

d) "**Subject-to-tax" test**: The New CIT Law introduces a new "subject-to-tax" requirement: the foreign entity should be subject to a nominal CIT rate of at least 10%, although this requirement is deemed to be met if the foreign entity is resident in a jurisdiction with a tax treaty with Spain including an exchange of information clause.

   If the first-tier foreign subsidiary obtains dividends and gains from second and lower-tier entities, the New CIT Law provides that the participation

[3] This applies only to profit participating loans granted after 20 June 2014

[4] However there is a grandfathering provision for existing ETVEs

[5] Without prejudice of the potential application of Spanish CFC rules

exemption on dividends and gains from this first–tier foreign entity would only apply to (proportional rule)[6]:

i. The portion of the dividends distributed by the first-tier subsidiary that is paid out of dividends and gains from second and lower-tier entities meeting the "subject-to-tax" test, and

ii. The portion of the capital gain attributable to unrealized reserves of the first-tier subsidiary that can be allocated to those underlying second and lower-tier entities meeting the "subject-to-tax" test.

We note that, under the existing participation exemption regime, if non-qualifying dividends and gains, or non-qualifying shareholdings, represent less than 15% of the total income or assets of the first-tier foreign subsidiary, the full dividend and capital gain could be exempt in Spain. But, if the non-qualifying dividends/gains or assets exceed the 15% threshold, the full dividend or gain is tainted. The New CIT Law replaces this "all-or-nothing" calculation rule with the above described "proportional" rule.

e) "**Anti-tax haven" rule is maintained (but only partially)**: Like in the existing exemption regime, the New CIT Law confirms that the participation exemption would not apply when the foreign subsidiary is resident in a tax haven jurisdiction (except if resident in the EU and it can be evidenced that it has been incorporated for good business reasons and it carries on business activities). However, the New CIT Law does not prevent the application of the participation exemption when the buyer of the shares is located in a tax haven (as opposed to existing legislation).

f) **New special rules** applicable to **hybrid instruments and equity derivatives:**

i. Participation exemption shall not apply to those dividends that are characterized as a tax deductible expense in the entity distributing the dividend

ii. Interest on hybrid financial instruments representing share capital of the issuer (for example, non-voting shares, redeemable shares), and interest on profit participating loans granted to group entities[7] shall be characterized as dividends and could benefit from participation exemption, unless the interest is tax deductible in the borrower's jurisdiction; and

iii. The New CIT Law provides a special rule for derivatives when the legal holder of the shares is not the beneficial owner of the dividend, such as stock loans or equity swaps. In these cases, the exemption is granted to the entity that economically receives the dividend (through a manufactured dividend or compensation payment), and not to the formal holder of the shares, provided that certain conditions are met.

5.2 CFC rules: Scope of application is extended

New categories of income added to the "passive income" list

When a foreign subsidiary is regarded as a "CFC entity" (that is, an entity with an effective tax rate below 75% of the Spanish tax, in which the Spanish shareholder holds, individually or together with related parties, a participation of 50% or more in its capital, equity, profits or voting rights), current Spanish CFC rules provide a "closed" list with the categories of income that should be deemed "passive income" for CFC purposes.

This list has been criticized by scholars because it excludes certain sources of income deriving typical passive income, and now the New CIT Law completes the list with the following:

a) Income derived from capitalization and insurance contracts, when the beneficiary is the same CFC entity

b) Income derived from intellectual property, when the CFC entity is not the author, and from industrial property, when it is not connected with business activities carried on by the CFC entity

c) Income derived from providing technical assistance, except when provided in the context of a business activity

d) Income derived from the lease of movable assets, a business or mines, when the lease is not carried out as a business activity, and

e) Income from the assignment of image rights, when this assignment is not carried out in the context of a business activity.

Existing CFC rules provide that the passive income of the CFC entity should not be attributed to the Spanish shareholder when the sum of all the passive income is lower than 15% of the total income, calculated at the level of the CFC entity or aggregating the total income

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[6] There are special rules if this test is met only in some fiscal years

[7] This applies only to profit participating loans granted after 20 June 2014

of all the non-Spanish subsidiaries of the same accounting group.

Now, the New CIT Law provides that this 15% threshold shall be measured at the level of the CFC entity on an individual basis, and also that the passive income derived from financial activities and services to Spanish related entities should be attributed regardless of this threshold (with certain exceptions), which means that former situations not falling within CFC rules may now be caught by them.

New "total-income" imputation rule

In addition to the closed "passive income" list, the New CIT Law introduces a general imputation rule providing that the "total income" (and not only the passive income) of a CFC entity should be attributed to the Spanish shareholder when the CFC entity does not have enough "substance" (that is, human and material resources) to carry on its activity.

However, the New CIT Law clarifies that this rule would not apply when (i) the activity is carried on with the substance of another non-Spanish entity belonging to the same accounting group, or (ii) the existence and operations of the CFC entity can be justified with valid commercial reasons.

6. Tax losses on shareholdings still deductible, subject to certain conditions

Impairment losses on shareholdings are no longer tax deductible since 2013. However, the tax loss generated as a consequence of the disposal of the shareholding in a Spanish or non-Spanish entity, or resulting from the liquidation of such entity (amounting to the difference between the fair value of the shares and their tax base cost), would be generally tax deductible, even if the shareholding qualifies for the Spanish participation exemption, with the following limitations:

a) Losses incurred on transfers of shares in a (Spanish or not) subsidiary to another entity (Spanish or not) of the **same accounting group**, shall not be tax deductible until such shares are transferred outside the group (in this regard the New CIT Law provides that the amount of the deductible tax loss shall be reduced if the sale to the third party is made at a gain, unless the gain is subject to effective taxation), or the acquirer/transferor of the shares ceases to form part of the group.

   However, this limitation shall not apply in cases of extinction of the transferred entity (except when such dissolution is made under the tax neutrality regime applicable to mergers and divisions), and

b) Losses incurred on the transfer of shares in a (Spanish or not) subsidiary shall not be tax deductible up to an amount equivalent to (i) capital gains obtained in previous transfers of homogeneous shares that benefitted from participation exemption, and to (ii) the **dividends** distributed by such entity since the tax period starting in 2009, to the extent that such dividends have not reduced the tax base cost in the shareholding but have been exempt in Spain or have generated dividend tax credits.

7. Use of carryforward tax losses: New rules

The New CIT Law makes permanent the existing temporary limitation (since 2011) to the use of carried forward tax losses, but increases the existing thresholds and allows using the tax losses indefinitely. However, the New CIT Law worsens the change of control rule and the statute of limitation period of tax losses carried forward.

7.1 Carryforward tax losses can offset only up to 70% of taxable income, but without time limit

Transitional regime in 2015

During 2015, as a transitional measure, the New CIT Law provides that the transitional tax regime currently applicable in 2014 shall be extended, which implies that carryforward tax losses can only offset up to 25% of the positive taxable income (before the deduction of the capitalization reserve described below) of companies or tax groups with a turnover in the previous fiscal year higher than €60 million (and up to 50% of the taxable income if the turnover is between €20 and €60 million).

Regime in 2016 onwards

In 2016 onwards, the New CIT Law provides that carryforward tax losses can offset up to 70%[8] of the annual positive taxable income (calculated before the deduction of the capitalization reserve), irrespective of the turnover of the company or tax group. In any case, carryforward tax losses up to €1 million can be used without any limitation.

On the other hand, the New CIT Law states that tax losses can be carried forward for use indefinitely, without time limit (now they can be carried forward for use in the following 18 years only, and they expire if not used within this period).

[8] In 2016 the percentage shall be 60% pursuant to an amendment included in the Budget Act for 2015

We note that the New CIT Law envisages three situations where the 70% limitation shall not apply (and thus the carryforward tax loss can fully absorb the taxable income of the year):

a) When the carryforward tax losses are used to offset the taxable income derived from debt waivers resulting from an agreement with creditors[9],

b) When the company is dissolved or liquidated, except if the dissolution is implemented under the tax neutrality regime applicable to mergers and divisions, and

c) To taxable income derived from the recapture of impairment losses that were tax deductible in previous years, when the carryforward tax losses now applied had been substantially generated by such impairment losses.

7.2 Tax Authorities can review carryforward tax losses generated in previous 10 years

The New CIT Law extends to 10 years (starting from the due date to file the tax return where the tax loss is generated) the statute of limitation period to review carryforward tax losses (and tax credits) generated in previous years (general limitation period is four years).

Once this 10-year limitation period has elapsed, the Tax Authorities cannot review the correctness of the calculation of carryforward tax losses (or tax credits), but the taxpayer should be able to provide in a tax audit (i) the tax return of the tax period when the carried forward tax loss (or tax credit) was generated, and (ii) the accounts of the fiscal year when the tax loss (or tax credit) were generated, and evidence that those accounts have been deposited with the Mercantile Registry.

This amendment tries to solve the controversy created by recent tax rulings issued by the Spanish Supreme Court, which have been construed by the Tax Authorities as a right to audit carryforward tax losses and tax credits generated in time-barred tax periods without any limitation.

[9] This exception is applicable already in 2014, but it is restricted to agreements with creditors that are non-related with the debtor (this restriction shall still apply in 2015 in application of the transitional regime).

7.3 Change of control may lead to forfeiture of carryforward tax losses

Currently Spanish CIT Law only foresees the forfeiture of carryforward tax losses as a consequence of the change of control in the Spanish company when the Spanish company has been dormant during the six months prior to the change of control.

The New CIT Law includes additional situations where the change of control would trigger the forfeiture of the carryforward tax losses, namely:

a) When, within the two years following the change of control, the Spanish entity undertakes a business activity different or additional to the one carried on before the change of control, and the net sales derived from this new activity in these two years is higher than 50% of the average net sales figure of the Spanish entity in the preceding two years; or

b) When the Spanish entity is a passive holding company, as defined in the Spanish CIT Law.

7.4 Carryforward tax losses can be taken over in acquisition of a business unit

The New CIT Law allows the transfer of carryforward tax losses to the acquiring entity in demergers/contributions of business units, even if the transferring entity is not extinguished (the existing position of the Spanish Tax Authorities is that carryforward tax losses can only be transferred when the transferring entity is extinguished).

7.5 Deferred tax assets derived from temporary differences: New limitation for tax deductibility

Deferred tax assets derived from certain non-deductible accounting provisions can be deducted as a tax adjustment in the following tax periods, but the New CIT Law provides that this tax deduction cannot exceed the limit of 70% of the annual positive taxable income (calculated before the inclusion of the tax adjustments derived from these deferred tax assets, before the deduction of the capitalization reserve and before the use of carryforward tax losses).

The New CIT Law provides a transitional regime in 2015, similar to the one for the use of carryforward tax losses.

8. Incentive to strengthen net equity of Spanish entities: Tax deductible "capitalization reserve"

In order to stimulate the strengthening of the net equity of Spanish entities by keeping retained earnings

undistributed, the New CIT Law introduces a so-called tax deductible "capitalization reserve".

Basically this "capitalization reserve" enables a tax deduction in the company's annual taxable income amounting to up to 10% of the increase in its net equity during the year (that is, comparing the net equity at year end (excluding profits of the year), with the net equity at the beginning of the year (excluding profits of the previous year), and without taking into account any shareholder contributions and other specific items). This tax deduction is capped at 10% of the taxable income of the year, and any excess can be carried forward for use in the following two years.

To utilize this tax relief the amount of the net equity increase would need to be maintained during the following five years after the tax deduction is applied (except in the case of accounting losses), and the company should recognize a specific reserve in its statutory accounts for the amount of the tax deduction (this capitalization reserve cannot be distributed during the following five years, except in certain situations).

In the case of a tax group, the tax deduction of the capitalization reserve would need to be calculated on a tax group basis, although the accounting reserve can be recognized by any of the tax group's entities.

9. Tax neutrality regime applicable to mergers and demergers: Relevant amendments

9.1 Scope for tax neutral partial demergers is extended

The New CIT Law expands the scope of the definition of partial demerger (*escisión parcial*) that can benefit from tax neutrality. Currently, when the transferring entity transfers a business unit in a partial demerger, in order to benefit from tax neutrality it should keep another business unit (different from a shareholding). Now, the New CIT Law allows the application of the tax neutrality when the transferring entity keeps a controlling stake in a subsidiary.

9.2 Demerger/contribution of business units can bring carryforward tax losses generated by the business unit

Also, the New CIT Law allows the transfer of carryforward tax losses to the acquiring entity together with the business unit transferred, even if the transferring entity is not extinguished (the existing position of the Spanish Tax Authorities is that carryforward tax losses can only be transferred when the transferring entity is extinguished).

9.3 Merger goodwill no longer tax deductible

The New CIT Law provides that goodwill and other intangibles arising as a consequence of a merger following a share deal shall no longer be tax deductible if the share deal has been closed in 2015 onwards. The New CIT Law justifies this tax change arguing that capital gains incurred by Spanish sellers on the disposal of shareholdings in Spanish entities shall no longer be taxable, and thus there is no double taxation to be mitigated.

However we note that there would still be double taxation when the seller is a Spanish individual, the selling Spanish entity did not meet the participation exemption requirements, or a non-Spanish resident entity or individual is taxed in Spain on such gain in application of the relevant tax treaty with Spain.

9.4 Challenge of tax neutrality no longer triggers "tax charge" of unrealized gains

Under current tax legislation, if the Spanish Tax Authorities challenge the application of the tax neutrality regime on the basis that the merger, demerger or exchange of shares have not been carried out for valid business reasons, but mainly to obtain a tax advantage, the consequence of this tax assessment is not only the rejection of the tax advantage obtained, but also the taxation of the unrealized gains of the dissolved entity (what is colloquially called the "tax charge of the *dead* entity" or "*plusvalía de la muerta*").

Now, the New CIT Law expressly provides that the Tax Authorities can only regularize the tax advantage unduly taken, but cannot claim the tax charge on the unrealized gains of the dissolved entity.

This is a substantial change to be taken into account when analysing the pros and cons of undertaking a corporate reorganization (that is, now, many reorganizations cannot be undertaken without an advanced binding ruling from the Tax Authorities, because the risk of the "tax charge of the *dead* entity" is not assumable).

10. Tax grouping regime: Main amendments

10.1 Changes in the perimeter of the CIT tax group

Spanish sister entities with a non-Spanish parent (and Spanish subs indirectly owned) can now form a tax group

The New CIT Law, in application of EU doctrine, now allows Spanish subsidiaries with a common non-Spanish parent (or Basque parent) to form a Spanish

tax group, and also to include in the tax group those Spanish subsidiaries (or permanent establishments) in which the shareholding is held through a non-Spanish (or Basque) holding company.

We note that, if the tax group regime is elected, all the Spanish direct or indirect subsidiaries of the ultimate non-Spanish parent should be included in the same tax group. This means that multinational groups with several tax groups in Spain (because each Spanish division or subgroup is held by a different non-Spanish holding company) may be obliged to form a single Spanish tax group if they are controlled ultimately by the same parent[10].

Parent should now have majority of voting rights

Also, we note that, in addition to the current ≥75% shareholding requirement that the parent entity should hold, directly or indirectly, in the share capital of the Spanish subsidiary (reduced to 70% if the subsidiary is a listed entity), now the New CIT Law requires that the parent company also should have the majority of the voting rights in the subsidiary (in the past it was not unusual to have structures with different classes of shares to keep the subsidiary within the tax group even if the majority of the voting rights have been transferred to a third party).

10.2 No "de-grouping tax charges" if the former tax group is included in a new group

With the existing legislation, when an existing tax group is broken because it joins a new tax group, the existing tax group should recapture the previous tax adjustments for profits/losses derived from intra-group transactions, and should allocate the carryforward tax losses and other tax credits generated by the tax group proportionally to each of the group entities that generated these tax losses, which means that those carryforward tax losses and credits could only be used by those entities on a standalone basis, against its own taxable income (that is, we refer to the above as the "de-grouping" tax charges).

This situation is fairly common when a non-Spanish investor acquires a Spanish group through a Spanish BidCo/SPV, which becomes the parent entity of a new Spanish tax group and breaks the existing Target's tax group.

Now, the New CIT Law provides that the inclusion of an existing tax group into another tax group, as a consequence of the existing parent entity becoming a subsidiary of another parent, or being merged into an entity of other tax group, would not trigger the de-grouping tax charges (that is, carryforward tax losses and credits can be used by the entities of the former tax group as if they were taxed as a "subgroup" of the new tax group).

Also, we note that the New CIT Law provides that, when a subsidiary leaves the tax group and this subsidiary has generated a profit or loss in an intra-group transaction that was eliminated from the tax group's consolidated taxable income, it should be the subsidiary, and not the tax group (as happens today), who should recognize the recapture of the tax adjustment in its individual taxable income in the fiscal year when it leaves the tax group. This would be particularly relevant in the tax due diligence of a tax group's subsidiary, as the de-grouping tax charges could be claimed to the acquired subsidiary (and no longer to the tax group).

Finally, the New CIT law clarifies in a transitional provision that the recapture of an eliminated intragroup capital gain derived from the transfer of shares could benefit from the participation exemption regime provided in the New CIT Act (even if the participation exemption was not applicable when the capital gain was eliminated from the tax group's taxable base).

10.3 Changes in the requirements to form a VAT Group

The Tax Reform amends several provisions of Spanish VAT Law, including some provisions related to Spanish VAT Groups:

a) It is clarified that a pure holding company can be the parent entity of a VAT Group, even if it is not deemed a taxable person for VAT purposes, and

b) The parent entity should have a participation of more than 50% of the share capital or voting rights of the subsidiaries in order to form a VAT Group (currently a participation of 50% in the capital is sufficient). This new requirement shall enter into force as of 1 January 2016 for existing VAT Groups.

11. Tax depreciation of intangibles is reviewed

Transitional regime in 2015

During 2015, as a transitional measure, the New CIT Law provides that the transitional tax regime currently applicable in 2014 shall be extended, which implies that goodwill and other intangibles with indefinite useful life, either arising in an asset deal or as a consequence of a merger after a share deal, can be amortized for tax purposes (even in the absence of accounting

[10] The New CIT Law defers this situation to year 2016, in order to give more time to adapt to this change.

impairment) at a maximum annual rate of 1% and 2% respectively.

Regime in 2016 onwards

However, the New CIT Law provides that in 2016 onwards both goodwill and other intangibles with indefinite useful life can be amortized for tax purposes at a **maximum annual rate of 5%**, even if the seller and the purchaser belong to the same accounting group (the New CIT Law clarifies that this tax regime shall not apply to intangibles acquired before 1 January 2015 when the seller and the purchaser belonged to the same accounting group).

Intangibles with definite useful life can be amortized over the useful life of the intangible.

Restrictions to goodwill and other intangibles arising in mergers after a share deal

As anticipated, the New CIT Law provides that goodwill and other intangibles arising as a consequence of a merger following a share deal shall no longer be tax deductible if the share deal has been closed in 2015 onwards. The New CIT Law justifies this tax change arguing that capital gains incurred by Spanish sellers on the disposal of Spanish shareholdings shall no longer be taxable, and thus there is no double taxation to be mitigated. However we note that there would still be double taxation when the seller is a Spanish individual, or a Spanish entity failing to meet the participation exemption requirements, or a non-Spanish entity or individual who is taxed in Spain on such gain in application of the relevant tax treaty.

12. Assets' accounting impairments non-tax deductible (until loss actually incurred)

As above mentioned, in 2013 the Spanish CIT Law was amended to prevent the tax deductibility of losses on impairments of shareholdings.

Now, the New CIT Law extends this restriction to **accounting impairments or unrealized losses** of **tangible/intangible non-current assets and debt instruments**, which shall not be tax deductible until the losses are actually incurred, as a result of amortization, disposal (to a third party outside the group) or removal of the assets from the balance sheet. Bad debt provisions (subject to certain requirements) and accounting impairment of inventories are still tax deductible.

Also, we note that the **tax loss generated as a consequence of the disposal** of the tangible /intangible non-current asset or debt instrument to another entity (Spanish or not) of the **same accounting group**, shall not be tax deductible until such assets are removed from the balance sheet, transferred to a third party outside of the group, or when the transferor or acquirer leaves the group or during their useful life if the assets are amortized for tax purposes.

13. Amendment to transfer pricing rules

The New CIT Law has introduced some changes to transfer pricing rules, which mainly refer to:

a) Change in the definition of "related parties": As from 1 January 2015 a shareholder shall only be regarded as a related party to the participated entity when it holds a shareholding of at least 25% (now the threshold is 5%, and 1% when the participated entity is listed). Other situations have been removed from the definition of related parties (for example, two shareholders investing in a JV company, when one of them controls the JV, now shall not be deemed to be related parties)

b) The secondary transfer pricing adjustment shall not be applied if there is a repatriation of funds (i.e. payment of funds so that the accounts of the parties involved are in line with the economic intent of the primary transfer pricing adjustment), and

c) Advance pricing agreements (APAs) can have effects in previous years, except if time barred.

14. Tax credits: Some are abolished, other are maintained

The New CIT Law **abolishes the reinvestment tax relief** (which can reduce the effective CIT rate of a capital gain from 30% to 18%, if certain requirements are met) and the environmental tax credit, but it **keeps the tax incentives for intangibles** (that is, the tax credit for research & development & innovation activities, and the patent box regime).

15. Changes with impact in real estate transactions

The Tax Reform includes some changes that could be relevant for an investor in real estate:

a) The Tax Reform eliminates, when calculating the capital gain obtained by a Spanish entity or individual in the transfer of real estate assets, the **inflation adjustment coefficients** (applicable depending on the acquisition date of the property) to mitigate the deemed impact of inflation. This

amendment would result in higher taxable gains for the Spanish sellers (or a lower tax loss)

b) In order not to be regarded as "passive income" for certain tax purposes (that is, application of participation exemption, CFC rules), when a Spanish investor invests in **rental property** outside Spain it is essential that the lease of real estate qualifies as a **"business activity" for tax purposes**. In this regard:

   i. The New CIT Law still requires a full-time employee with a labor contract to be assigned to the lease activity in order to qualify as a business activity, but has eliminated the office space requirement, and

   ii. Moreover, what is more relevant, the New CIT Law states that in the case of a group of companies, this requirement should be met at a group level, as opposed to at a "single-entity" level. This change would now allow Spanish entities to invest in real estate assets outside Spain through separate SPVs, and benefit from participation exemption on dividends and gains derived from these SPVs, without the need to have a full-time employee and office space in each of the SPVs.

c) The VAT exemption on second-supplies of real estate assets can now be waived even if the purchaser does not have the right to deduct 100% of the input VAT borne. This would allow mitigating the Transfer Tax cost when the purchaser applies the pro rata VAT rule because the real estate asset is partially used for activities that are exempt from VAT, and

d) The Tax Reform also includes some minor amendments to the tax regime applicable to SOCIMIs (Spanish REITs): Now (i) dividends distributed to a SOCIMI shall not be subject to withholding tax at source, and (ii) SOCIMI's non-resident investors with a shareholding of less than 5% in the SOCIMI can benefit from the capital gains exemption applicable to transfers in listed shares (provided that the investor is resident in a jurisdiction with a tax treaty signed with Spain including an exchange of information clause).

16. Changes to taxation of dividends and capital gains obtained by individuals

The Tax Reform also amends the Spanish PIT Law, and includes several changes to the taxation of dividends and capital gains obtained by Spanish residual individuals. The most significant are the following:

a) **Tax rates** applicable to dividends, interest and capital gains are reduced from 21%-27% (the top rate applies to income/gains above €24,000) to 20%-24% in 2015 and to 19%-23% in 2016 (with the Tax Reform the top rates apply to income/gains above €50,000)

b) As anticipated, the Tax Reform eliminates, when calculating the capital gain obtained by a Spanish individual in the transfer of real estate assets, the inflation adjustment coefficients to mitigate the deemed impact of inflation

c) Existing Spanish PIT Law provides a transitional regime for the taxation of capital gains derived from the transfer of **assets or rights acquired before year 1994**, which basically reduces the taxable gain allocated proportionally to the part of the holding period until year 2006. The Tax Reform **substantially amends this transitional tax regime**, which on transfers made from 1 January 2015 onwards can apply up to only an aggregated transfer value of €400,000 (except in the case of gains derived from listed shares and participations in collective investment schemes, which can benefit from the transitional tax regime up to the market price they had for Wealth Tax purposes in year 2005). This amendment may imply that taxable gains on the sale of non-listed shares or real estate assets acquired before year 1994 could be substantially higher if sold from 1 January 2015 onwards

d) Currently, capital gains generated in less than one year are taxed at the progressive tax rates. Now with the Tax Reform any capital gain shall be taxable at the flat tax rates (19%-23% in 2016, 20%-24% in 2015)

e) Gains derived from the **transfer of pre-emptive rights on listed shares** shall now be taxable (currently the sale proceeds reduce the tax base cost in the shares, implying that the taxable gain is deferred to the sale of the shares). This amendment shall come into force as of 1 January 2017

f) **Distributions paid out of share premium or a share capital reduction of non-listed shares** shall now be taxed as "dividends", up to the amount of the positive difference between the net equity of the distributing entity (proportional to the shareholding held, and excluding non-distributable legal reserves) and the tax base cost of the shareholding. The excess over this limit shall reduce the tax base cost in the shares. Currently such distributions first reduce the tax base cost, and the excess is taxable, so in practice this change would imply an anticipation of taxes (in fact this amendment prevents existing tax deferral schemes when the

company making the distribution has generated retained earnings during the holding period of the individual shareholder), and

g) **The Tax Reform introduces an "exit tax"** when a Spanish individual that has been resident in Spain for at least 10 years in the last 15 years transfers its tax residence out of Spain and has unrealized gains on shares. Specifically, the Spanish individual should pay capital gains tax on the difference between the fair value of the shares and their tax base cost, even if the shares are not alienated, if certain requirements are met (for example, fair value of the shares exceeds € 4 million, or the shareholding is >25% and the fair value of the shares is > €1 million). It is possible to suspend the payment of this exit tax in certain cases, and to even mitigate this exit tax if the Spanish individual moves back its tax residency to Spain without having transferred the shares.

This "exit tax" targets the potential tax planning of Spanish individuals planning to sell their shareholdings, preventing the transfer of their tax residency in order to sell the shares when they are non-Spanish residents and can benefit from tax treaty exemptions.

17. Executives' compensation schemes: Impact of the Tax Reform

17.1 Reduction in marginal rates for salary income

Salary income is taxed at progressive rates. Current marginal tax rate is 52% in the State, plus the regional surcharge (which increases the marginal rate up to 56% in some regions).

The Tax Reform reduces the marginal rate to 47% in 2015 and to 45% in 2016. However, the impact of this reduction in the marginal rate should be analyzed on a case by case basis, because with the Tax Reform the marginal rate applies to income from €60,000 onwards, whereas in the current PIT Law the top marginal rate applies to income exceeding €300,000 (i.e. income between €60,000 and €300,000 is subject to progressive rates between 47% and 51%).

17.2 Bonus payments generated over more than two years are taxed with a 30% reduction

Under existing tax legislation, bonus payments generated over a period of more than two years can be included in the PIT taxable base with a reduction of 40% of its gross amount, provided that these bonus payments are not obtained on a periodical or ongoing basis. There are special rules if the bonus is paid in instalments, and the 40% reduction applies up to a maximum annual amount of €300,000 (except in the case of income derived from the exercise of stock options, where this cap is substantially lower).

The Tax Reform keeps this tax reduction for salary income generated over more than two years, and the same limit of €300,000, but includes the following amendments:

- The reduction percentage is reduced from 40% to 30%
- The payment should be made in a single year (not in installments)
- The tax reduction shall not apply if the executive has received in the previous five years another bonus payment which has benefited from this reduction (dismissal severance payments are excluded for this purpose), and
- The tax reduction applicable to income from the exercise of stock options is subject to the same €300,000 cap.

The Tax Reform includes transitional provisions in the case of bonuses agreed before 1 January 2015 to be paid in instalments as from such date, and for stock options granted before 1 January 2015.

17.3 Income tax incentive for expatriates (the formerly-called "Beckham" law)

Under existing tax legislation, expatriates coming to Spain and becoming Spanish tax residents can elect to be taxed as a non-Spanish resident in the year of arrival and for the following five fiscal years, which means that they will only be taxed on the Spanish-source income (and not on their worldwide income) at a flat 24.75% tax rate, rather than at the progressive tax rates applicable to Spanish tax residents (current marginal tax rate varies from 52% to 56%, depending on the Spanish region).

This tax incentive is subject to certain conditions, and is applicable only when the salary does not exceed €600,000 annually.

The Tax Reform keeps this tax incentive but includes some improvements:

- Expatriates with salary income exceeding €600,000 annually can now apply this incentive. However, the flat rate (24%) would only apply to the first €600,000, and the excess would be subject to the marginal rate applicable to residents (47% in 2015, 45% in 2016)

- The tax incentive is also applicable to directors in a Spanish company, when they do not have a shareholding in the Spanish company or the shareholding does not reach 25%, and
- It is no longer required that the work is effectively carried on in Spanish territory and provided to a Spanish entity or permanent establishment.

On the other hand, we note that professional sportsmen have been expressly excluded from this incentive.

17.4 Limit to the tax exemption on severance payments

Currently, severance payments on dismissal are tax exempt up to the minimum obligatory amounts established in Spanish employment law.

However, with the Tax Reform the exemption would only apply up to an amount of €180,000. The excess could benefit from the 30% tax reduction for income generated over a period of more than two years, subject to the €300,000 cap (in this case the reduction applies even if paid in instalments, subject to certain requirements).

18. Changes to taxation of non-residents

18.1 New exemption for capital gains derived from (non-real estate) Spanish shares

EU resident corporates obtaining capital gains from Spanish shares, even if not listed, shall now be tax exempt in Spain, pursuant to a domestic exemption, if the requirements for the Spanish participation exemption are met (see above). However this exemption shall not apply when the assets of the Spanish company consist mainly, directly or indirectly, of immovable property situated in Spain.

We note that, until 31 December 2014, the domestic exemption does not cover capital gains of non-listed Spanish shares when the EU shareholder has owned 25% of the share capital or equity of the Spanish company in the 12-month period preceding the sale.

This would benefit EU shareholders that are resident in a jurisdiction with a tax treaty with Spain which allows Spain to tax capital gains from substantial shareholdings (e.g. Spain/France tax treaty).

18.2 Shareholding threshold for dividend withholding tax exemption is relaxed

With the Tax Reform the dividend withholding tax exemption provided by the Spanish provisions implementing the EU Parent/Subsidiary Directive would apply even if the EU parent has a shareholding in the Spanish subsidiary below the minimum 5% threshold, provided that the EU shareholder has an acquisition value higher than €20 million.

This would allow foreign investors investing in Spanish listed entities to benefit from the withholding tax exemption on dividends even if they do not reach the minimum 5% shareholding threshold.

18.3 Reduction of withholding tax rates

Existing standard 21% withholding tax rate applicable to dividends, interest and capital gains shall be reduced to 20% in 2015 and to 19% in 2016 (without prejudice to applicable domestic and tax treaty exemptions and reduced rates).

Existing standard 24.75% tax rate on other types of income shall be reduced to 20% in 2015 and to 19% in 2016 for taxpayers who are resident in the European Economic Area and to 24% in the rest of cases.

18.4 New rule for distributions paid out of share premium or share capital reductions

The Tax Reform provides that distributions paid out of share premium or a share capital reduction of non-listed shares shall now be taxed, up to the amount of the positive difference between the net equity of the distributing entity (proportional to the shareholding held, and excluding non-distributable legal reserves) and the tax base cost of the shareholding. The excess over this limit shall reduce the tax base cost in the shares.

We note that currently such distributions first reduce the tax base cost, and the excess is taxable, so in practice this change shall imply an anticipation of taxes, unless a withholding tax exemption is applicable under a tax treaty (in fact this amendment prevents existing tax deferral schemes when the company making the distribution has generated retained earnings during the holding period of the non-resident shareholder).

18.5 Changes to Wealth Tax and Inheritance and Gift Tax to adapt to EU Law

The Tax Reform also amends certain provisions of the Spanish Wealth Tax and Inheritance and Gift Tax applicable to non-resident individuals, in order to make them compatible with EU Law. Basically, non-resident individuals that are tax resident in a EU or EEA member State would now be entitled to apply the tax reliefs approved by the Autonomous Region where the assets or rights concerned are located (there are different "connection points" depending on the taxable event), instead of the State legislation, which is normally more burdensome.

19. Other recent and expected changes with an impact on M&A transactions

19.1 Implementation of AIFMD may restrict cash distributions to PE Funds

The implementation in Spain of the EU Directive on Alternative Investment Fund Managers (AIFMD) could have an impact on the ability to make distributions from the Spanish Target entities to the Spanish BidCo in order to pay the cash interest on the third party debt or to push down acquisition debt to the Target. This would affect Spanish BidCos owned by Spanish private equity funds and other alternative investment funds, and also to non-EU Funds registered in Spain.

Specifically, the recently approved Law 22/2014, of 12 November, implementing AIFMD provides that, within the 24 months after taking control of a non-listed target entity, the target entity cannot make distributions out of capital reductions or share premium under certain circumstances.

We note that this may damage the possibility to distribute cash to BidCo to repay cash interest or principal on acquisition debt, and also debt push down strategies when BidCo has funded the acquisition with bridge loans and pretends to refinance or repay this bridge loan with a debt push down to Target.

19.2 Non-listed Spanish groups can issue debt without withholding tax

Recently enacted Law 10/2014 has included a very relevant change affecting the scope of the issuers who can benefit from the special tax regime applicable to preference shares and certain debt instruments, which provides for a withholding tax exemption for non-resident investors, in the same terms as income from Spanish public debt.

So far, only credit institutions or listed entities (directly or through fully-owned Spanish or EU-resident special purpose vehicles, except if located in a tax-haven territory) could issue preference shares or debt instruments subject to the special tax regime, which is now extended to debt instruments issued by any non-listed Spanish resident company or public-law companies ("*entidades públicas empresariales*"), directly or through a fully-controlled EU-resident special purpose vehicle (except if located in a tax haven territory), provided that the debt instrument meets the requirements described in this first additional provision of Law 10/2014 (for example, they should be listed in regulated markets, multilateral trading facilities, or in other organized markets).

The inclusion of non-listed groups and public law companies in the scope of the special tax regime would certainly facilitate their financing by non-Spanish investors, by removing the withholding tax cost.

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