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Spain Tax Alert

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Corporate tax reform enacted

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The broad-based tax reform originally proposed by the Spanish government in June 2014 was published in the official gazette on 28 November 2014. The reform, which will become effective on 1 January 2015, includes the introduction of a new corporate income tax law, as well as extensive changes to the personal income tax, nonresident income tax and value added tax (VAT); changes to the general tax law still are pending approval.

The enacted corporate income tax bill ("bill") and the nonresident income tax modifications reflect some changes from the draft bill circulated in June (for details of the draft bills, see the alert dated 2 July 2014 and the *World Tax Advisor* article dated 12 September 2014).

The following summarizes the major changes that may affect multinational businesses.

Tax rate

The general corporate income tax rate of 30%—one of the highest in Europe—will be reduced to 28% for 2015 and to 25% in taxable years starting from 2016.

Tax-deductible expenses

- For taxable years starting from 1 January 2015, in response to the base erosion and profit shifting (BEPS) initiative, a special anti-abuse rule for hybrids will disallow deductions for expenses incurred in transactions with related parties where, as a result of different tax characterizations, either (1) no income will be generated, (2) income will not be subject to tax or (3) income will be subject to a nominal tax rate of less than 10%.
- Intragroup profit participating loans granted from 20 June 2014 will be characterized as equity instruments rather than debt and, therefore, "interest" payments on such loans will be nondeductible.
- The general limit on the deductibility of net financial expenses (i.e. 30% of EBIDTA) that exceed EUR 1 million will remain unchanged. The net financial expenses that exceed the deductibility limits may be carried forward indefinitely (currently, the carryforward period is 18 years). An additional limit will be introduced for leveraged vehicle acquisitions that form a consolidated group or involve a merger from 20 June 2014. This limit will restrict the deductibility of interest on loans obtained to purchase

shares in a company to 30% of the acquiring company's operating profit (without taking into account the operating profit of the acquired entity). This measure aims to restrict debt push-downs on leveraged acquisitions where the target and the acquisition vehicle form a consolidated tax group or are merged. This limit will not apply in the taxable year in which the shares are acquired if the acquisition is funded with debt not exceeding 70% of the acquisition price. In addition, the limit will not apply in subsequent taxable years, provided the debt decreases proportionally in each of the eight years following the acquisition date, to 30% of the acquisition price.

- For taxable years starting from 1 January 2015, the impairment of tangible fixed assets, real estate investments, intangible fixed assets (including goodwill), securities representing a capital or equity shareholding in an entity and debt securities will be nondeductible for tax purposes. Losses derived from these items will be deductible only where transferred to unrelated third parties or when they are actually written off from the balance sheet. This measure will complement the recent abolition of deductions for impairment losses with respect to shares representing an equity participation in the capital of a Spanish or foreign entity.
- The depreciation tables are simplified, but accelerated depreciation for R&D activities will remain intact.
- The tax treatment of intangible fixed assets will be as follows:
  - Intangible fixed assets with a definite useful life will be amortized for tax purposes based on their useful life (the previous law established a 10-year depreciation period).
  - The acquisition price of intangible fixed assets with an indefinite useful life (including goodwill) will be tax deductible over a 20-year period, irrespective of the amortization for accounting purposes. However, under a transition rule for taxable year 2015, the amortization deduction for intangible fixed assets with an indefinite useful life will be 2% of the basis in general, and 1% for goodwill.

  To compensate for the negative effect of the reversal of the temporary measures related to the 30% depreciation limitation (applicable in taxable years 2013 and 2014) and the step-up of balance sheet items due to the corporate income tax rate decreases, a new tax deduction of 5% (2% for taxable years starting in 2015) will apply to those reversals.
- Customer or supplier entertainment expenses will be deductible only up to 1% of the company's turnover.

Tax loss carryforwards

Several substantial changes are made to the rules governing net operating losses (NOLs):

- NOLs will be available for carryforward indefinitely (currently, NOLs may be carried forward for 18 years).
- NOLs generally will be able to be set off against only up to 70% of the taxable base prior to the application and funding of the capitalization reserve (described below); however, NOLs that do not exceed EUR 1 million will be able to be set off without limitation. The limitation will not apply to income derived from the reversal of impairments, provided the impairment deduction in the taxable year in which the NOLs were generated amounted to at least 90% of the deductible expenses in that taxable year. Under a transition rule, the existing NOL offset limitations

(50% for companies with a turnover of between EUR 20 million and EUR million and 25% for companies whose turnover exceeds EUR 60 million) will continue to apply for 2015.

- The change in control rules for entities with NOLs will be modified. The use of NOLs of an acquired entity will be disallowed under certain circumstances, including (among others) where the acquired entity has been dormant in the past three months (currently, six months) or where, within the two years after the acquisition, the acquired entity carries out different (or additional) activities from the activities it carried out before the acquisition that generate turnover that exceeds more than 50% of its average turnover for the two years prior to the acquisition.
- The tax authorities will be granted the right to audit and review NOLs for a period of 10 years from the time the NOLs arise (the existing standard review period under the statute of limitations is four years).

Tax credits

Several tax credits will be abolished (including the environmental investment credit, the reinvestment credit and the profit investment credit) and will be replaced by a capitalization reserve.

The capitalization reserve aims to strengthen Spanish entities' net equity by keeping retained earnings undistributed. The capitalization reserve will permit a tax deduction for 10% of the increase in net equity in a particular tax year, provided the company maintains the net equity increase during the following five years (except in the case of accounting losses) and books an undistributable reserve for the same amount. The deduction may not exceed 10% of the taxable base before the deduction, adjustments for deferred tax assets and the use of NOLs. The excess may be carried forward for the following two years, subject to the applicable limit for each year.

The R&D tax credit will be maintained and, in certain cases, the deduction rate may be up to 50% of qualified expenses. The scope of R&D will include advanced software activities, which currently are excluded from the benefits of the credit. Taxpayers still may receive a cash rebate for excess R&D.

Participation exemption

Under Spain's participation exemption, dividends and capital gains are exempt from tax if received by a Spanish entity that holds at least 5% of the share capital or equity of a foreign entity for a continuous period of at least one year, provided the foreign entity paying the dividends is subject to a tax comparable to the Spanish corporate income tax (this requirement is deemed to be met if the dividend-paying entity is resident in a country that has concluded a tax treaty with Spain that contains an exchange of information clause) and is resident in a country that is not a tax haven, with at least 85% of its profits deriving from business activities.

The bill introduces changes to both the type of income that may benefit from the exemption and the requirements to qualify for the regime. The most relevant changes are the following:

- In response to the European Commission's request to stop the discriminatory treatment of investments in foreign companies, a participation exemption regime is introduced for dividends and capital

gains derived from Spanish subsidiaries, replacing the current domestic tax credit to avoid double taxation.

- Under the existing regime, one of the requirements to benefit from the participation exemption on dividends or capital gains is that the Spanish company generally must hold, directly or indirectly, at least 5% of the share capital or equity of the dividend-paying foreign company. This requirement also will be met if the acquisition price of the participation exceeds EUR 20 million. A Spanish company subject to the holding company (ETVE) regime may qualify for the participation exemption with a participation of lower than 5% if the acquisition price of the participation exceeds EUR 6 million. Under the bill, the qualifying participation price is increased to EUR 20 million (for all entities). A transitional regime will allow existing investments made before 1 January 2015 that meet the EUR 6 million threshold, but not the EUR 20 million threshold, to qualify.
- The bill abolishes the active trade or business requirement, replacing it with a requirement that the foreign subsidiary be subject to 10% nominal tax rate. Under the bill, this minimum level of taxation is deemed to be met if the foreign subsidiary is resident in a tax treaty country.
- A new anti-hybrid measure will operate to prevent the application of the participation exemption where the dividend constitutes a deductible expense for the payer.

Transfer pricing

Changes to Spain's transfer pricing rules include the following:

- The definition of related parties will be revised so that shareholders and entities (whether or not listed) will be deemed to be related where the shareholder participation is at least 25% (currently 5%).
- The hierarchy of valuation methods to determine the fair market value will be abolished, and other methods will be accepted, provided they respect the principle of fair competition.
- Simplified documentation requirements will be introduced for entities that are not members of the same consolidated group and whose turnover does not exceed EUR 45 million.
- The penalty regime will be made less burdensome.

Special regimes

The bill includes changes to the consolidated tax regime, the tax-neutral regime for reorganizations and the controlled foreign corporation (CFC) regime.

Consolidated tax regime: Measures are included in response to the recent decision of the Court of Justice of the European Union that the Dutch fiscal unity regime is incompatible with the freedom of establishment principle in the EU treaty. Currently, a group of corporations may form a consolidated balance sheet, provided they have a common Spanish parent. The following changes are made to the consolidation regime:

- The percentage of voting rights required to form a consolidated group will remain at 75% (70% for listed companies), but the Spanish parent will be required to hold more than 50% of the voting rights.
- Spanish subsidiaries held indirectly through a foreign intermediary company will be able to be part of a consolidated group, as well as Spanish subsidiaries held directly or indirectly by a foreign parent (i.e. horizontal tax consolidation).

- Permanent establishments of foreign entities will be permitted to become members of a Spanish consolidated group if certain requirements are met.

Tax-neutral regime for reorganizations: The most relevant changes are the following:

- Goodwill and asset step-ups resulting from a merger will be not recognized for tax purposes (and therefore are not amortizable). However, merger goodwill and asset step-ups will be respected for transactions taking place after 1 January 2015 if acquisition of the absorbed entity took place before 1 January 2015.
- NOLs attributable to an acquired entity's activities will be able to be carried over to the acquiring entity (in cases of mergers, partial or total spinoffs and contributions in kind). Under the current legislation, this is possible only if the company that originally generated the NOLs is extinguished (in cases of mergers and total spin-offs).

CFC regime: Changes are made to the CFC rules in response to the BEPS initiative. A Spanish entity will be required to include in its taxable base income derived by a CFC from the transfer of assets and rights, or service income earned by a CFC where there are no material and personnel resources at the level of the CFC. Additionally, certain types of income (e.g. income derived from industrial and intellectual property, technical assistance and image rights) will be deemed to be passive income and, therefore, subject to the CFC rules.

Under the current CFC regime, de minimis rules do not require an income pickup at the Spanish entity level if the foreign company´s passive income does not exceed more than 15% of the foreign company's total net income or 4% of total gross income. The bill abolishes the 4% total gross income threshold and establishes special rules to calculate the 15% total net income threshold. Under the bill, the 15% total net income will need to be calculated on a standalone basis, and no longer at a consolidated level.

Nonresident income tax

Income derived by a nonresident (i.e. a nonresident without a permanent establishment in Spain) generally is subject to a final tax of 24.75%, although different rates may apply depending on the type of income. For example, dividends, interest and capital gains are subject to a 21% withholding tax rate. The reform reduces the general 24.75% rate down to 19% (20% in 2015 and 19% as from 2016) for income derived by residents of the EU/EEA and to 24% as from 2015 for all other nonresidents. The withholding tax rate on dividends, interest and capital gains will be reduced from 21% to 20% in 2015, and to 19% in 2016.

To avoid discriminatory treatment between capital gains obtained by corporate residents and EU residents, the reform extends the participation exemption regime to capital gains obtained by EU resident companies, unless the assets of the transferred entity consist (directly or indirectly) mainly of real estate located in Spain.

Share premium distributions currently reduce the tax basis of shares, with any distribution exceeding the amount of share premium being treated as dividends. Under the new law, share premium distributions made by an unlisted company will be treated as dividends to the extent of the profits earned by the distributing company during the period in which the shares have been held by the recipient. For nonresidents, this may have an impact on the amount of the distribution that is subject to Spanish withholding tax.

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