Spain releases draft bill of Spanish tax system reform

Executive summary
In 2013 the Spanish Government announced its intention to carry out a reform of the Spanish tax system to be effective in 2015 with the aim to boost the Spanish economy. Within this context, on 23 June 2014, draft bills modifying the most important Spanish tax laws were released.

This Alert covers some of the most relevant new measures proposed in the Corporate Income Tax (CIT) and Nonresidents' Income Tax (NRIT) laws. The legislative procedure of these draft bills as well as the proposed transitory regime will be closely monitored. A more detailed Alert will follow as the approval process progresses.

Detailed discussion

Corporate Income Tax
The draft bill gradually reduces the CIT rate from 30% to 25% in 2016 with an interim 28% rate applicable in 2015 while eliminating most of the tax deductions and other benefits.

The following is a summary of other relevant proposals:

- The Government proposes to broaden the taxable base by limiting the deductibility of certain expenses, such as the impairment of assets.

- The general limitation to the tax deductibility of net financial expenses (30% operating profit) with the minimum deductibility threshold of €1 million is maintained. An additional limitation is proposed for leveraged acquisitions, consisting in limiting the deductibility of interest on loans to purchase shares to 30% of the operating profit of the acquiring entity; rules are included so that such limits apply where the acquired and acquiring entities are merged or join the same tax unity. Under the draft bill's transitory provisions this limitation could be interpreted so as to affect transactions implemented after 20 June 2014, although it remains to be seen how the final wording of these provisions will be enacted.
• In line with the foregoing, intra-group profit sharing loans are characterized as equity instruments for Spanish tax purposes.

• In response to the European Commission’s request to end the discriminatory taxation of investments in nonresident companies (Case 2010/4111), the Government proposes to extend the current participation exemption regime provided for dividends and capital gains derived from foreign subsidiaries to those derived from Spanish subsidiaries (with a scaled limitation for transfers taking place during 2015 and 2016), substituting the current domestic tax credit to avoid double taxation.

An additional proposal consists of the amendment of the requirements for the application of the participation exemption regime, so that this will be conditioned to: (i) a minimum ownership percentage (5%) or cost of acquisition (€50 million) and a one-year minimum holding period in the subsidiary; (ii) for foreign subsidiaries only, a minimum level of (nominal) taxation of 10% under a foreign corporate tax system similar to the Spanish CIT. The legal presumption pursuant to which the current subject-to-tax test is deemed to be met when the foreign subsidiary is tax resident in a tax treaty country is eliminated. Notably, the draft bill also eliminates the so-called “business activity test” (commonly referred to as the “85/15 rule”) as a requirement to access the participation exemption benefits, but introduces certain additional substance requirements. The proposed rules also introduce a new system for the calculation of exempt dividend and gains derived from multi-tiered structures, where some of the entities within the chain of ownership are not compliant with the participation exemption requirements. These rules also affect ETVE (Spanish international holding) structures.

These same proposed changes have also been introduced in the foreign branch exemption rules.

• The amendments introduced in the draft bill regarding the Spanish transfer pricing rules include changes in the related party perimeter (new 25% participation threshold), suppression of the order established for the use of the valuation methods and simplification of the documentation requirements for companies with a net turnover lower than €45 million.

• The reinvestment credit and the profit investment credit are both suppressed and substituted by a capitalization reserve pursuant to which companies can reduce their taxable base in an amount equal to 10% of the increase of their net equity on a given year, provided they book a non-disposable reserve for the same amount.

• The draft bill proposes to amend the rules applicable to the utilization of Net Operating Losses (NOLs), eliminating the current 18-year limitation and establishing a yearly quantitative limit of 60% of the positive taxable base for tax years starting on or after 1 January 2016 (the current limitations continue to apply in 2015). However, a minimum €1 million threshold is set (i.e., NOLs up to €1 million will be able to be used with no limits).

• In line with the decision issued on 12 June 2014 by the Court of Justice of the European Union (CJEU) whereby it concluded that the Dutch tax consolidation regime is not compatible with the EU freedom of establishment because it does not allow the so-called “horizontal tax consolidation,” the Spanish Government proposes to modify the Spanish tax consolidation rules, which are very similar to the Dutch provisions, to include those fact patterns where two Spanish companies have a, direct or indirect, common non-resident shareholder, as long as the latter is not resident in a tax haven for Spanish tax purposes.

• The draft bill also introduces certain amendments in the area of anti-abuse rules in line with OECD-BEPS (Base Erosion and Profit Shifting) project. In particular, amendments are included in relation to the tax treatment of hybrid instruments and the Spanish Controlled Foreign Companies (CFC) rules, including, for instance, additional substance requirements in the foreign CFC in order to avoid imputation of foreign low-taxed income.
Nonresidents’ Income Tax

The following is a summary of the most relevant amendments to this tax included in the draft bill:

- The temporarily increased domestic tax rates applicable to income obtained by non-Spanish tax residents acting in Spain without a permanent establishment (in the absence of applicable reduced tax treaty rates or other tax benefits) are reduced back to the original rates. In addition, the 24% general tax rate will be progressively lowered to 19% for income obtained by European Union or EEA (European Economic Area) tax residents:

<table>
<thead>
<tr>
<th>Rate</th>
<th>2014</th>
<th>2015</th>
<th>2016</th>
</tr>
</thead>
<tbody>
<tr>
<td>General tax rate</td>
<td>24.75%</td>
<td>24%</td>
<td>24%</td>
</tr>
<tr>
<td>Tax rate applicable to EU and EEA residents</td>
<td>24.75%</td>
<td>20%</td>
<td>19%</td>
</tr>
<tr>
<td>Dividends, interest and capital gains general rate</td>
<td>21%</td>
<td>20%</td>
<td>19%</td>
</tr>
</tbody>
</table>

- In line with the CIT proposed amendments, the tax rate applicable to permanent establishments in Spain is reduced from 30% to 28% in FY 2015 and to 25% from FY 2016 onwards.

- The Spanish NRIT rules provide for a 0% withholding tax on dividend and royalty payments made to EU resident recipients, where certain requirements are met. These provisions include anti-abuse clauses that seek to avoid the application of the exemptions in those cases where the ultimate shareholder of the EU recipient is not an EU resident entity and the EU intermediate company is utilized primarily to benefit from the exemption.

The interpretation of the anti-abuse rule applicable to intra-EU dividend payments has generated considerable conflict. With the proposed legislation, the Spanish Government’s stated purpose is to clarify the requirements which must be met for the exemption on dividend and royalty payments to apply where the EU recipient is majority-controlled by a non-EU shareholder and, at the same time, tighten the scope of cases that can benefit from these exemptions, requiring activity in the EU recipient entity other than holding activity.

- As a result of a proposed change in the Personal Income Tax Law, share premium distributions made to non-Spanish resident shareholders may be treated as dividend distributions, in lieu of a return of basis, and therefore be subject to withholding tax under the general rules.

- Minority (less than 5%) shareholders in listed SOCIMIs (Spanish REITs) will be exempt from Spanish capital gains.

Potential effect on Spanish taxpayers and on international investment structures into Spain

These proposed base-broadening, deduction-limiting rules, and the inclusion of widened anti-abuse provisions, if the rules are approved as released, will affect current investment structures, both inbound and outbound. Inbound, for instance, in relation to the limitation to the deductibility of financial expenses in leveraged acquisitions, dividend withholding tax on dividends for non-EU investors using EU holding companies and on share premium distributions, or in respect of exit planning, since now the proposed rules allow for an exemption on gains also within Spain.

Outbound structures, including ETVE structures, may need to be reviewed in order to assess compliance with the new conditions for the application of the international participation exemption rules, especially on multi-layer corporate structures. Among other parameters, substance, level of taxation (in particular, where treaty eligibility will not be a safe-harbor any more) and a new system of tracing of “bad income and gains” may be needed.

All of these items will of course need to be closely monitored as the legislative proposals evolve within the parliamentary discussions, but special attention should be paid to action that may be advisable to take before the new rules enter into force.
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EYG No. CM4531