



Taxation of cross-border mergers and acquisitions

Spain

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Introduction

This report explains how recent tax changes are likely to affect the approach to mergers and acquisitions (M&A) in Spain. The report then addresses three fundamental decisions faced by a prospective purchaser:

- What should be acquired: the target's shares or its assets?
- What should be used as the acquisition vehicle?
- How should the acquisition vehicle be financed?

Tax is, of course, only one part of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of the report. Some of the key points that arise when planning the steps in a transaction are summarized later in the report.

On 28 November 2014, the Spanish government approved one of the most far-reaching reforms of the Spanish tax system in the recent years. The tax reform impacts the Spanish tax position of sellers and buyers in M&A transactions, and the tax cash flow projections of Spanish entities. The reforms generally come into force on 1 January 2015, and special attention should be paid to the transitional rules.

The tax reform encompasses:

- a new corporate income tax (CIT) law (Law 27/2014)
- a new law amending the personal income tax (PIT) and non-resident income tax (NRIT) (Law 26/2014)
- a new law amending the value added tax (VAT) (Law 28/2014).

Some of these new rules have been amended in line with the Organisation for Economic Co-operation and Development's (OECD) final recommendations under its Action Plan on Base Erosion and Profit Shifting (BEPS).

As a consequence, as of January 2015, most transactions performed in Spain are covered by the new CIT law, which embeds the tax regime for mergers, splits and other reorganization transactions covered in European Union (EU) directives in the Spanish tax system. This tax regime, which can be complex, should be considered at each phase of an acquisition. Specific anti-avoidance provisions may apply, and local advice should be sought.

Recent developments

The following summary of recent Spanish tax changes is based on current legislation up to 31 January 2016.

Since the 2014 edition of this report, the main modifications for M&A purposes were implemented by the following regulations:

- Law 26/2014, dated 27 November 2014
- Law 27/2014, dated 27 November 2014
- Royal Decree 634/2015, dated 10 July 2015
- Law 22/2015, dated 20 July 2015
- Law 28/2014, dated 27 November 2014
- Law 36/2014 dated 26 December 2014
- Law 34/2015 dated 21 September 2015
- Law 48/2015 dated 29 October 2015.

Corporate income tax rate

The standard CIT rate was reduced to 28 percent (from 30 percent) in 2015, and to 25 percent in 2016 and later years. Other reduced rates can apply for special entities.

Additional limitation for leveraged buy-out (LBO)

As of 1 January 2012, two limitations affecting to the tax deductibility of financial expenses were introduced in the Spanish CIT law:

- so-called 'earnings-stripping' tax rules, which derogated and substituted the previous 'thin-capitalization' regime
- a specific limitation preventing the deductibility of financial expenses incurred on acquiring participations from other group entities or for making capital contributions into other group entities.

Law 27/2014 also introduced an ‘anti-leveraged buy-out’ (anti-LBO) provision restricting the deductibility of acquisition financing as of 1 January 2015. The new CIT law provides for a new rule that limits the tax-deductibility of interest accruing on acquisition debt, where such interest can be offset against the taxable profits of the target entities acquired (through the applicability of the fiscal unity regime or a post-acquisition merger).

Under the anti-LBO rule, for purposes of assessing the 30 percent operating profits threshold applicable under the new earnings-stripping rules, the operating profits of the target entities acquired (and which were included in the acquirer’s fiscal unity, or merged with or into the acquirer) should be excluded.

Several limitations to this rule should be considered:

- This rule only applies within the 4 years following the leveraged acquisition (i.e. the inclusion of an entity in a fiscal unity, or the performance of a post-acquisition merger after the fourth anniversary of the acquisition, should not trigger the anti-LBO rule).
- Under an ‘escape clause’, this rule does not apply if the portion of the purchase price financed with debt does not exceed 70 percent of the total purchase price. In later fiscal years, the applicability of the escape clause requires the amortization of the principal amount of the acquisition debt on an annual basis (at a 5 percent rate) until the principal amount is reduced after 8 years to 30 percent of the purchase price.
- This new regime will enter into force with retroactive effect from 20 June 2014. In practice, this means that if the target company belonged to the acquirer’s fiscal unity before that date (i.e. both were taxed under such fiscal unity regime in a fiscal year starting before 20 June 2014), the new regime will not be applicable either.

Limitations on carry forward of losses

For financial year (FY) 2016, Law 27/2014 provides that carried forward tax losses can offset up to 60 percent of the annual positive taxable income (calculated before the deduction of the capitalization reserve (see capitalization reserve section), irrespective of the turnover of the company or tax group.

In any case, carried forward tax losses up to 1 million euros (EUR) can be used without limitation. The percentage limit is increased to 70 percent for FYs beginning in or after 2017. The law 27/2014 states that tax losses can be carried forward for use indefinitely (previously, carried forward tax losses expired after 18 years).

During 2015, carried forward tax losses can only offset up to 25 percent of the positive taxable income (before deduction of the capitalization reserve) of companies or tax groups with a turnover in the previous fiscal year higher than EUR60 million (and up to 50 percent of the taxable income if the turnover is between EUR20 and 60 million).

Tax losses: change of control restrictions

The CIT law restricts the transfer of tax losses on a change of ownership where:

- the majority of the capital stock or the rights to share in the income of the entity has been acquired by a person or entity or by a group of related persons or entities after the end of the tax period to which the tax losses relate
- such persons or entities hold less than 25 percent at the end of the tax period to which the tax losses relate
- the acquired entity:
 - has not performed any economic operations in the 3 months prior to the acquisition, or
 - has performed a different or additional economic activity during the 2 years after the acquisition that generates a net turnover value over the 50 percent of the net turnover corresponding to the 2 prior years, or
 - is a ‘passive holding company’, as defined in the Spanish CIT law, or
 - has been removed from the index of organizations for not filing its corporate income tax return corresponding to three consecutive tax periods.

Extension of the Spanish tax authorities’ time to review tax losses and tax credits

A new statute of limitations period of 10 years applies to years in which an entity generates tax losses and/or tax credits (the general limitation period is 4 years). Once this 10-year limitation period has elapsed, the Spanish tax authorities cannot review the correctness of the calculation of carried forward tax losses (or tax credits), but the taxpayer should be able to provide:

- the tax return of the tax period in which the carried forward tax loss (and/or tax credit) was generated
- the official accounting records of the fiscal year when the tax loss (or tax credit) were generated filed with the Spanish Commercial Registry.

Extension of the participation exemption regime to Spanish subsidiaries

As of FY2015, the participation exemption regime is extended to dividends or capital gains from Spanish subsidiaries, provided certain requirements are met:

- The Spanish entity must hold, directly or indirectly, at least 5 percent of the share capital or equity of the Spanish or foreign companies or, failing this, an acquisition value of at least EUR20 million.
- A 1-year uninterrupted holding/maintenance period is met.

- The subsidiary is subject to a minimum level of (nominal) taxation of 10 percent under a foreign corporate tax system similar to the Spanish CIT (non-resident subsidiaries only). This requirement is deemed to be met when the foreign subsidiaries are resident in a country that has signed a tax treaty with Spain that includes an information exchange clause.

The CIT law also introduces a system for calculating exempt dividends 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.

This exemption does not apply to capital gains derived directly or indirectly from:

- entities passively holding assets
- Spanish or EU economic interest group
- controlled foreign companies (CFC) obtaining more than 15 percent of, 'passive income', as defined by the CFC rules (which may imply checking compliance with the substance requirement at the level of the CFC).

The exemption does not apply to any gains on the transfer of holdings in entities resident in a country or territory classified as a tax haven, unless they reside in an EU member state and can demonstrate that their formation and operations are based on valid economic reasons and they engage in economic activities.

Neutralization of the effect of hybrid mismatches

Law 27/2014 introduces certain amendments to anti-abuse rules in accordance with the OECD BEPS project.

In this respect, the deductibility of expenses is disallowed with respect to related parties that, due to a different classification for tax purposes, do not generate income, generate exempt income or are taxed at a rate of less than 10 percent (hybrid transactions).

Additionally, intragroup profit-participating loans (PPL) are characterized as equity instruments for Spanish tax purposes. As a consequence, interest payments with respect to PPLs granted as of 20 June 2014 by an entity belonging to the same group would be assimilated to dividend distributions, so they would not be considered as a tax-deductible expense, regardless of the tax residency of the lender. (Under previous tax legislation, interest accrued under PPLs were tax-deductible where it complied with the general rules stated in Spanish CIT law for the tax-deductibility of financial expenses).

Capitalization reserve

The capitalization reserve is a new tax benefit effective as of 1 January 2015. Under this benefit, companies can reduce their taxable base in an amount equal to 10 percent of the increase of their net equity during a given year, provided they

book a non-disposable reserve for the same amount and keep it in their balance sheet for 5 fiscal years.

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.

Amendments in the tax neutrality regime

Spanish CIT law incorporates the tax regime applicable to mergers, spin-off and other reorganization transactions covered in EU directives. Generally, asset transfers carried out through such transactions do not have any tax implications (either from a direct, indirect or other Spanish tax perspective) for the parties involved (transferor, beneficiary and shareholder) until a subsequent transfer takes place that is not protected by this regime.

When applying for the benefits of this regime, it is critical to have a relevant sound business reason for the merger, other than merely achieving a tax benefit (i.e. tax saving or deferral).

As of FY2015, this tax neutrality regime was amended as follows:

- The tax neutrality regime becomes the general regime for reorganizations unless the taxpayers elect for the general tax regime (taxable).
- Where the Spanish tax authorities challenge the application of the tax neutrality regime on the basis that the transactions have not been carried out for valid business reasons but mainly to obtain a tax advantage, the new CIT law expressly provides that the tax authorities can only regularize the tax advantage unduly taken; they cannot claim the tax charge on the unrealized gains of the dissolved entity.
- The new CIT law expands the scope of the definition of 'partial spin-off' (*escisión parcial*) that can benefit from the tax neutrality regime. Law 27/2014 allows the regime's application when the transferring entity keeps a controlling stake in a subsidiary.
- Merger goodwill or the step-up of assets on a merger no longer have tax effects (deferred tax liabilities (DTL) may crystallize in this case). The new CIT law includes transitional rules for acquisitions of shares before 1 January 2015. Double taxation can arise where the shares are purchased from Spanish resident individuals.
- Carried forward tax losses can be transferred together with a branch of activity to the acquiring entity. Under prior legislation, this was only possible if the company owning the tax losses was extinguished (mergers and total spin-offs).

New rule for share premium redemption or share capital reduction

As of 1 January 2015, the repayment of the share premium is deemed as a dividend distribution to the extent of the positive reserves generated during the holding period. If no positive reserves exist, the share premium redemption would not have Spanish tax effects (i.e. it would reduce the tax cost of the shares).

Impairment of tangible, intangible and real estate assets

As of 1 January 2015, losses on the impairment of tangible, intangible and real estate assets, which were previously tax-deductible under certain circumstances, are deductible only if they are sold to third parties or if they are depreciated during their useful life.

Asset tax depreciation

For tax periods starting in 2013 and 2014, Spanish tax law imposed a limitation for 'large-sized companies' (i.e., companies with a turnover of, or being part of a mercantile group with a turnover, exceeding EUR10 million in the preceding financial year). These entities may only take 70 percent of the maximum depreciation rates for tax purposes corresponding to fixed assets.

The depreciation expense considered non-tax-deductible according to the above is deductible on a linear basis over a 10 year-period or, optionally, over the remaining lifetime of the assets, for FYs starting in 2015 and later.

To mitigate adverse tax consequences from the reduced CIT rate (which was 30 percent before FY2015), the Spanish CIT law introduced a new tax credit that would apply on the recapture of accounting depreciations that were not deducted in FY2013 and FY2014. The rates of this tax credit are 2 percent for 2015 and 5 percent for 2016 and future years. Unused tax credits may be carried forward indefinitely.

New tax treatment of intangible assets and goodwill

Intangible assets, such as patents, may be amortized if they depreciate and have a limited useful life. For the 2012, 2013 and 2014 tax years, they are generally amortized at an annual rate of 10 percent, unless it can be proved that their useful life is shorter than 10 years.

Under certain circumstances, goodwill and intangible assets with an indefinite life are amortizable for tax purposes. As of 1 January 2015, the maximum annual depreciation rate is 5 percent. However, for the 2015 tax year, the maximum annual depreciation rate is 2 percent for intangible assets and 1 percent for goodwill. As of 1 January 2015, it is possible to deduct goodwill amortization even in the case of an acquisition by group companies.

Notwithstanding the above, Audit Law 22/2015, dated 20 July 2015, modifies the tax treatment of intangible assets as follows:

- Intangible assets recognized in the accounts fall within a single category: 'intangible assets with a defined useful life'. However, a new subcategory is created: 'intangible assets whose useful life cannot be reliably estimated'. These assets will be amortized over 10 years unless a different period is provided for in another law.
- Goodwill may be included as an asset when it is acquired in 'onerous basis' and, in principle, will be amortized over 10 years.

As a result of these amendments, for tax years starting in 2016 and later, the amortization expense of intangible assets must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent) and the tax percentage (5 percent) requires book-to-tax adjustments in order to determine the taxable base for CIT purposes.

New tax consolidation rules

Although the tax consolidation regime remains nearly the same in terms of calculation of the tax base, there are several relevant changes regarding the perimeter of the tax group.

In this respect, as of 1 January 2015, in line with several EU court cases, Law 27/2014 allows the application of the tax consolidation regime to those structures 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, thereby allowing the so-called 'horizontal tax consolidation'. The non-resident shareholder should comply, among others, with the following requirements:

- It owns, directly or indirectly, at least 75 percent of the other company's share capital (70 percent for companies quoted on the stock exchange) and it maintains such ownership and a minimum 50 percent of voting rights in such entities for the entire tax year of consolidation.
- It is not a subsidiary of another company fulfilling the requirements to be regarded as the controlling company.

Finally, permanent establishments of foreign companies will also be able to form part of a tax group, not only as the dominant entity but also as a member of the group.

Controlled foreign company rules

As of 1 January 2015, the Spanish CFC rules were amended to include, among others, additional substance requirements to be met by the foreign subsidiary in order to avoid the imputation of the foreign low-taxed income.

EU directives: new anti-abuse rules

The requirements for the application of the EU Parent-Subsidiary Directive and EU Royalties Directive were modified to prevent abusive situations in which the majority of the participation in the parent company was held by non-EU resident companies. Under the amendment, it is necessary in such cases to evidence the existence of valid economic purposes and solid business reasons for the incorporation of the EU parent company.

Tax credits

The new CIT law abolishes the reinvestment tax credit (which reduced the effective CIT rate of a capital gain if certain requirements were met) and the environmental tax credit. The tax incentives for intangibles (i.e. research and development (R&D) tax credit, patent box regime) are retained.

Patent box regime

As of 1 July 2006, Spanish patent box regime has been significantly amended. Under this regime, Spanish companies can benefit from a partial tax allowance on the net income ('qualifying income') received as a consideration for:

- the license of the rights to use or exploit of patents, drawings or models, plans, formulas or knowhow (i.e. secret procedures relating to industrial, commercial or scientific experience — 'qualifying intangible assets')
- the transfer of the property on the qualifying intangible assets.

Some features of the regime are unchanged (e.g. requisites related to the development of an economic activity and the tax residence of the licensee), and 'trademarks' and 'software' remain excluded of the scope of the qualifying intangible assets. Also, the new regulation still allows the taxpayer to request the Spanish Tax Administration to conclude advance agreements on the valuation of the gross income and expenditures related to a license contract and the qualification of a given intangible asset as eligible for benefit from the tax incentive.

The amendments mainly focus on two aspects of this tax incentive:

- determination of the partial tax relief applicable on the qualified income
- a revised transitional regime in accordance with the existing regulation for each period, starting from 29 September 2013.

These amendments aim to conform the Spanish patent box regime with the relevant agreements reached in the context of the European Union and the OECD (i.e. in line with the 'nexus approach' as defined by Action 5 of the OECD Action Plan on BEPS).

Transfer pricing

New transfer pricing rules have been introduced, including:

- changes to the definition of 'related party' (new 25 percent participation threshold)
- suppression of the order established for the use of the valuation methods
- simplification of the documentation requirements for groups with a net turnover lower than EUR45 million.

The penalty regime for failing to comply with transfer pricing rules and documentation requirements was also changed. A welcome improvement is the possibility of negotiating advanced pricing agreements (APA) that are retroactive within the statute of limitation period.

Moreover, new transfer pricing documentation requirements have been established:

- *Country-by-country report*: As of FY2016, Spain-based multinational entities having a turnover of EUR750 million or more are required to comply with a new country-by-country reporting standard and file the report in the 12 months following close of the fiscal year.
- *Master file reporting*: Spain-based multinational entities having a turnover greater than EUR45 million are required to file a new, extended version of the master file report — thereby increasing transfer pricing documentation burden for these entities.
- *Local file reporting*: The new rules for the local file require more information on competitors, a comparability analysis, and a detailed description of other non-typical methods (e.g. discounted cash flow) that are now allowed.

Value added tax

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 percent of the input VAT borne. This would mitigate 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 VAT-exempt.

Asset purchase or share purchase

Generally, a transaction can be performed as a share deal, in which the shares in the target entity are sold, or as an asset deal, in which the assets (and normally the associated liabilities) are the objects of the transaction.

The transfer of shares may allow the seller to mitigate its capital gains tax, for companies through participation exemption rules and for individuals through capital time-based gains reliefs. However, the purchaser cannot step-up the tax basis in the assets of the target and inherits any hidden capital gains and contingencies. Losses derived from an intragroup transfer may be compensated with limitations.

The sale of assets normally produces a taxable capital gain for the selling company (25 percent CIT rate for FY2016, temporarily increased to 28 percent for FY2015), which might be difficult to mitigate (although some tax benefits may be available). However, the acquiring entity gains a stepped-up tax basis. The purchaser of shares assumes the liabilities of the company acquired (although they might be covered by indemnities in the sale and purchase agreement), while the acquirer of individual assets does not assume the tax risks of the selling company unless the acquisition is made by one or several persons or entities that continue a going concern.

However, in an asset deal in which a complete business unit is transferred, the liabilities connected to the business are also transferred. In this case, the purchaser may limit its liability by obtaining a certificate from the Spanish tax authorities showing the tax liabilities and debts. The liabilities transferred then would be limited to those listed in the certificate.

Purchase of assets

Tangible assets

Most tangible assets, except land, can be depreciated for tax purposes and spread over the period of their useful economic life, provided the depreciation is based on the asset's recorded historical cost or on a permitted legal revaluation.

Special rules establish the specific depreciation percentages in force, which depend on the type of industry and assets involved. A maximum percentage of annual depreciation and a maximum depreciation period are established for each type of asset.

Intangible assets

Intangible assets with finite useful lives are amortized depending on useful life. Intangible assets with indefinite useful life are amortized at a maximum annual rate of 5 percent.

Notwithstanding the above, as of tax years starting in 2016, intangible assets recognized in the accounts fall within a single category: intangible assets with a defined useful life. However, a new subcategory is created: 'intangible assets whose useful life cannot be reliably estimated'. These assets are amortized over 10 years for accounting purposes, unless a different period is provided for in another law.

As a consequence, the amortization expense of intangible assets whose useful life cannot be reliably estimated must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent) and the tax percentage (5 percent) will imply book-to-tax adjustments in order to determine the taxable base for CIT purposes.

Goodwill

The premium paid by a purchaser of a business as a going concern could be due to a higher value of the assets acquired or to the existing goodwill. For FY2015, goodwill can be written down for tax purposes at a maximum annual depreciation rate of 5 percent (1 percent for FY2012—2015). The price allocated to each asset is tax-depreciated according to the individual asset's depreciation profile.

Notwithstanding the above, as of tax years starting in 2016, goodwill may be included as an asset when it is acquired in 'onerous basis' and, in principle, is amortized over 10 years for accounting purposes.

As a consequence, the amortization expense of the goodwill must be recognized for accounting purposes in order to be tax-deductible.

The difference between the accounting percentage (in principle, 10 percent), and the tax percentage (5 percent) will imply book-to-tax adjustments in order to determine the taxable base for CIT purposes.

Additionally, the new CIT law provides that goodwill and other intangibles arising as a consequence of a merger following a share deal are no longer tax-deductible if the share deal closes in 2015 or later years. The rationale for this tax change is that capital gains incurred by Spanish sellers on the disposal of shareholdings in Spanish entities are no longer taxable, so there is no double taxation to be mitigated.

Depreciation

Most tangible assets, except land, can be depreciated for tax purposes and spread over the period of their useful economic life, provided the depreciation is based on the asset's recorded historical cost or permitted legal revaluation.

Special rules specify maximum depreciation percentages and periods for specific industries and types of asset.

Depreciation rates higher than the officially established or approved percentages can be claimed as deductible expenses where the company obtains permission from the tax authorities or can support the depreciation applied.

As of FY2015, the limitation of the tax deduction for the depreciation of assets established during FY2013 and 2014 is eliminated.

Tax attributes

Pending tax losses and tax deduction pools are not transferred on an asset acquisition. They remain with the company or are extinguished. However, in certain cases, under the tax neutrality regime for reorganizations, it may be possible to transfer such tax attributes to the acquiring company.

Value added tax

VAT generally applies to the supply of goods or services by entrepreneurs and professionals, as well as to EU acquisitions and the importation of goods by all persons. The standard VAT rate is 21 percent.

Among others, VAT does not apply to transfers of sets of tangible or intangible elements that belong to a taxable person's business or professional assets and constitute an independent economic activity capable of carrying on an business or professional activity on their own, regardless of any special tax regime that may apply to the transfer.

The purchaser may deduct the VAT paid on inputs from the VAT charged on outputs and claim a VAT refund where the VAT paid exceeds the VAT charged monthly or quarterly. However, VAT paid on certain inputs, such as travel expenses, gifts and passenger cars, is non-deductible.

Transfer taxes

Corporate reorganizations defined in the tax-neutrality regime for CIT purposes are not subject to the 1 percent capital duty and are exempt from transfer tax and stamp duty. Also exempt from 1 percent capital duty are contributions in cash or in kind to the share capital or equity of a company and the transfer to Spain of the legal seat of a non-EU company.

Sales of real estate exempt from VAT (i.e. a second transfer of a building) are subject to a transfer tax at the rate established by the region in which the real estate is located, unless certain requirements are met and the transferor waives the VAT exemption. Sales of real estate included in a going concern may not be subject to VAT and thus are subject to transfer tax, without the possibility to elect being subject to VAT.

Stamp duty also applies to transactions, such as a sale of real estate, where the sale is subject to VAT and/or the taxpayer waives the VAT exemption on the transfer. There is compatibility between VAT and stamp duty.

Local taxes

Transfers of urban land (whether built on or not) are subject to a municipal tax on the increase in the value of urban land (TIVUL). TIVUL tax due depends on the holding period of the property and the land's cadastral value. The taxable base of the tax is determined by applying to the cadastral value of the land at the disposal date a certain percentage determined by multiplying the number of years the land was held (maximum 20 years) by a coefficient ranging from 3 to 3.7. The tax rate may be up to 30 percent.

Purchase of shares

Due diligence reviews

In negotiated acquisitions, the seller usually makes the target company's official books and tax returns available to the purchaser for due diligence review. An important part of the due diligence process is an in-depth review of the tax affairs of the potential target company by the advisors to the purchaser.

Local or state taxes

No local or state taxes are payable on the transfer of shares.

Tax indemnities and warranties

In negotiated acquisitions, it is common practice for the purchaser to ask the seller to provide indemnities or warranties for any undisclosed liabilities of the company to be acquired.

Tax losses

Tax losses under Spanish law can be carried forward without temporal limitation (an 18-year expiration period previously applied).

The tax losses cannot be offset where:

- the majority of the capital stock or of the rights to share in the income of the entity has been acquired by a person or entity or by a group of related persons or entities after the end of the tax period to which the tax losses relate
- such persons or entities hold less than 25 percent at the end of the tax period to which the tax losses relate, and
- the acquired entity:
 - has not performed any economic operations in the 3 months prior to the acquisition, or
 - has performed a different or additional economic activity during the 2 years after the acquisition that generates a net turnover value over the 50 percent of the net turnover corresponding to the 2 prior years, or
 - is a 'passive holding company' as defined in the Spanish CIT law, or
 - has been removed from the index of organizations for not filing its corporate income tax return for 3 consecutive periods.

For FY2016, Law 27/2014 provides that carried forward tax losses can offset up to 60 percent of the annual positive taxable income (calculated before the deduction of the capitalization reserve — see capitalization reserve section), irrespective of the turnover of the company or tax group. In any case, carried forward tax losses up to EUR1 million can be used without limitation. The percentage limit is increased to 70 percent for FYs starting in or after 2017.

Transfer taxes

VAT and transfer tax are not payable on the transfer of shares, except in certain cases mainly involving the sale of shares as a means of selling real estate. In such cases, where more than 50 percent of the company's assets by value consist of real estate not linked to its business activity and the acquirer receives more than 50 percent of the company's voting rights directly or indirectly, the transfer of the shares may be subject to VAT or transfer tax, to the extent that the parties involved in the transfer of shares act with the intent of avoiding the tax otherwise due on the transfer of immovable properties.

Stamp duty is not payable, but brokerage or notary fees, which are normally less than 0.5 percent of the price, are applicable.

Choice of acquisition vehicle

Several potential acquisition vehicles are available to a foreign purchaser, and tax factors often influence the choice.

Local holding company

A local holding company is the most common vehicle for transactions. There are two main types of limited liability companies: *Sociedad Anonima* (SA) and *Sociedad de Responsabilidad Limitada* (SL).

Both entities have their own legal status (legal personality). Each has a minimum share capital (EUR60,000 for an SA and EUR3,000 for an SL) and may have one or more shareholders. Both are governed by Royal Legislative Decree 1/2010, dated 2 July 2010, on Corporate Enterprises.

Foreign parent company

Spain does not charge withholding tax (WHT) on interest and dividends paid to EU recipients (see the European Council Interest and Royalties Directive 2003/49/EC and the EU Parent-Subsidiary Directive 90/435/EEC).

Some tax treaties reduce the applicable WHT rates, which are normally 19 percent for interest and dividends (20 percent from 1 January 2015 to 12 July 2015 and 19.5 percent from 13 July 2015 to 31 December 2015) and 24 percent for other income.

Non-resident intermediate holding company

Where the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Spain. However, the purchaser should be aware that certain Spanish treaties contain anti-treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits. Similarly, where the non-resident intermediate holding company reduces the Spanish WHT rate otherwise applicable, Spanish tax authorities may apply general anti-avoidance tax rules (GAAR) to challenge this structuring.

Local branch

The target company's assets or shares can be acquired through a branch. Although branches are taxed in a similar way to resident companies, they have the advantage of not attracting WHT on remittance of profits abroad, provided the foreign company resides in a tax treaty country or in the EU (with some exceptions).

Joint venture (and other vehicles)

Spanish partnerships engaged in business activities (*Sociedad Colectiva* or *Sociedad Comanditaria*) are treated as corporate taxpayers.

Choice of acquisition funding

A purchaser using a Spanish acquisition vehicle to carry out an acquisition for cash needs to decide whether to fund the vehicle with debt, equity or a hybrid instrument that combines the characteristics of both. The principles underlying these approaches are discussed below.

Debt

The investment may be financed on either the local or a foreign market. No limitations apply to local financing, provided the borrower is a Spanish resident. If the loan is granted by a non-resident, under the current exchange control system, the borrower must declare the loan to the Bank of Spain. Previously, the borrower had to obtain a number of financial operation by filing the appropriate form (PE-1 or PE-2), depending on the amount of the loan.

The principal advantage of debt is the potential tax-deductibility of interest (see the section on deductibility of interest later in the report), whereas the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses, such as guarantee fees or bank fees, in computing trading profits for tax purposes.

If it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt, there must be sufficient taxable profits against which interest payments can be offset.

Normally, the pushdown of debt has been a structuring measure to allow the offsetting of the funding expenses against the target's taxable profits.

Debt pushdowns implemented as intragroup transfers of shares are restricted as of 1 January 2012. Interest expenses are not deductible when derived from intragroup indebtedness incurred to acquire shares in other group companies, whether resident or not, unless the taxpayer provides evidence that the transaction is grounded in valid business reasons.

Additionally, the new CIT rule has introduced a new anti-LBO article. According to this rule, for purposes of assessing the 30 percent operating profits threshold applicable under the earnings-stripping rules described earlier, the operating profits of the target entities acquired (and which were included in the acquirer's fiscal unity, or merged with or into the acquirer) should be excluded.

Both joint stock companies (SA) and limited liability companies (SL) are barred from providing financing, fund assistance or guarantees for the acquisition of their own shares/participation or the shares/participation of their parent company. This restriction does not apply to companies lending in the ordinary course of their business or to loans made to employees.

Deductibility of interest

In addition to transfer pricing rules, there are other limits on the deduction of interest expenses on debt used to finance an acquisition, such as the general limitation on financial expenses and GAAR.

As of 1 January 2012, the deductibility of a company's net financial expenses is limited to up to 30 percent of the EBITDA. Undeducted expenses may be carried forward without temporal limit. Where the net interest expenses of

a taxable year are below the 30 percent limit, the unused difference (up to 30 percent of EBITDA) can be carried forward for 5 years. The 30 percent limit does not apply to net expenses up to EUR1 million.

Additionally, there are a number of situations in which a tax deduction for interest payments can be denied under increasingly complex anti-avoidance legislation. In particular, Spanish transfer pricing legislation, which applies to interest expenses and principal amounts, can restrict interest deductibility when the level of funding exceeds that which the company could have borrowed from an unrelated third party or where the interest rate charged is higher than an arm's length rate.

Transactions caught by the rules are required to meet the arm's length standard. Thus, where interest paid to an overseas (or Spanish) parent or overseas (or Spanish) affiliated company is in an amount that would not have been payable in the absence of the relationship, the transfer pricing provisions deny the deduction of the payments for Spanish tax purposes. According to the literal wording of the law, where both parties to the transaction are subject to Spanish tax, the authorities can adjust the results of the party whose benefits have been increased, so that there is usually no impact on the cash tax payable by the group (although losses can become trapped in certain situations).

The tax authorities could also reject the tax-deductibility of interest expenses under the anti-avoidance clauses in the general tax law (i.e. re-characterization of debt into equity).

Withholding tax on debt and methods to reduce or eliminate it

Generally, the payment of interest and dividends by Spanish residents is subject to 19 percent WHT (20 percent from 1 January 2015 to 12 July 2015 and 19.5 percent from 13 July 2015 to 31 December 2015). The WHT may be credited against the recipient company's income tax liability. Where certain requirements are met, the WHT on dividends is eliminated where the acquiring company holds a participation of more than 5 percent or a participation whose acquisition value has been over EUR20 million during an uninterrupted period of more than 1 year after the date of acquisition.

Additionally, this tax may be reduced or eliminated for dividends, interest and royalties, where the beneficiary is a resident of a tax-treaty country.

Checklist for debt funding

- The use of bank debt may avoid transfer pricing problems (but not the limitation on interest deductibility) and obviate the requirement to withhold tax from interest payments.
- Interest can be offset against taxable income of other entities within the tax group. Interest that cannot be offset immediately because of net operating losses can only be carried forward for offset against future profits of the entities within the tax group. Interest that cannot be offset immediately due to the general limitation on

interest deductibility may be carried forward without temporal limitation.

- Consider whether the level of profits would enable tax relief for interest payments to be effective.
- A tax deduction may be available at higher rates in other territories.
- WHT of 19 percent applies on interest payments to non-Spanish and non-EU entities unless lower rates apply under the relevant tax treaty.

Equity

It is possible to finance the acquisition with equity and debt. The distribution of dividends from the target to its shareholders as an alternative method of funding the acquisition is tax-assessable, although the shareholder may be entitled to a total or partial tax credit.

Tax-neutral regime for corporate reorganizations

There is a deferral regime in the Spanish CIT law for mergers, spin-offs, contributions in kind and exchanges of shares, among others. This was a special regime; however, as of the FY2015, the deferral regime is the general one. In order to not apply the deferral, the Spanish tax authorities must be notified.

This special regime is mainly aimed at achieving the tax-neutrality of corporate restructuring operations by deferring the taxation that could otherwise arise until the acquiring company transfers the assets acquired.

This tax-neutral regime applies provided that the restructuring transaction is supported with valid business reasons other than tax reasons (anti-abuse clause). In particular, where the main purpose of the reorganization is to obtain a tax advantage and the non-tax reasons are ancillary or not sufficiently relevant compared with the tax advantage obtained, the Spanish tax authorities would likely challenge the tax-neutrality regime.

The new CIT law expressly provides that, if the deferral requirements are not met, 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.

M&A transactions

Merger

Three kinds of merger are possible in Spain according to the tax definition of 'merger':

- *Mergers where the companies involved are dissolved (without liquidation) and their assets and liabilities are contributed to a newly incorporated company:* The shareholders of the dissolved companies receive shares in the new company in exchange for their shares in the merged companies and, if necessary, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

- *Mergers where an existing company absorbs one or more companies:* The shareholders of the absorbed companies receive new shares from the absorbing company and, if necessary, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.
- *Mergers where an entity, on being dissolved without liquidating, transfers its assets and liabilities to the company holding all the securities representing its share capital.*

Split

Three kinds of splits are possible in Spain:

- A total split occurs where a company separates its net equity into one or more parts and transfers them as a block(s) to one or more entities (which can be new or pre-existing) as a consequence of its dissolution without liquidation, and the transferring company's shareholders receive representative participation in the acquiring companies. This participation should be given to the shareholders in proportion to the shares they held in the split company, and, if appropriate, a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.
- A partial split occurs where a company separates part of its assets that represent an autonomous branch of activity and transfers it to one or more entities (new or pre-existing), receiving in compensation participations in the acquiring entity that should be allocated to its shareholders in proportion to their respective participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves, and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.
- A financial split occurs where a company separates part of its assets consisting of the majority shares in other companies (maintaining at least a controlling stake on a subsidiary or a branch of activity) and transfers it to a company (new or pre-existing), receiving as consideration shares in the acquiring entity that should be allocated to its shareholders in proportion to their participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves, and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the shares' nominal value.

Where the split involves two or more acquiring entities and the allocation of the shares of the acquiring entities to the shareholders of the transferring company is in a different proportion than their holding in the transferring company, each set of separated assets is required to constitute an autonomous branch of activity.

Contribution in kind

Through a contribution in kind, a company, without being dissolved, transfers an autonomous economic unit of activity to another entity, receiving in exchange shares issued by the acquiring company. The contribution may also consist of individual assets, provided certain requirements are met.

Exchange of shares

In an exchange of shares, an entity acquires a participation in the share capital of another entity that allows it to obtain the majority of voting rights. In exchange, the shareholders of the company acquired are given participation in the acquiring company and, if necessary, monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

Tax treatment

Transferring entity

Generally, the capital gains derived from the difference between the net book value and the market value of the goods and rights transferred as a consequence of the above transactions are not included in the transferor's CIT tax base.

Acquiring entity

The goods and rights acquired by an entity as a consequence of any of the transactions mentioned earlier would be valued for tax purposes at the same value they had in the transferring entity before the transaction took place. The payment of taxes is deferred until the acquirer subsequently transfers the assets involved in the transactions.

Shareholders

The income derived from the allocation of the acquiring entity's participations to the transferor's partners is not added to their taxable bases in certain situations specified in the legislation. For tax purposes, the participations received have the same value as those delivered.

Step-up and goodwill depreciation

The new CIT law provides that goodwill and other intangible assets arising as a consequence of a merger are no longer tax-deductible if the share deal closes in 2015 or later years.

The rationale for this change is that capital gains incurred by Spanish sellers on the disposal of shareholdings in Spanish entities are no longer taxable (due to the participation exemption regime), so there is no double taxation to be mitigated. The new CIT law provides for transitional rules for shares acquired before 1 January 2015.

Indirect taxation

All the transactions mentioned earlier, except contributions in kind consisting of individual assets, are exempt from or not subject to transfer tax or the local tax on urban land appreciation. These transactions are not subject to VAT where the assets and rights transferred constitute a 'branch of activity', as defined for VAT purposes.

Subrogation in tax rights and obligations

In the above transactions, all of the transferring entity's tax rights and liabilities are transferred to the acquiring company or, in the case of a partial transfer, only those relating to the goods and rights transferred. Where some of the transactions are covered by the special tax regime, the acquiring company can offset losses from the transferring entity, subject to certain limits.

Hybrids

Consideration should also be given to using hybrids, which are instruments treated as equity for accounting purposes for one party and debt (giving rise to tax-deductible interest) for the other. Following the OECD's BEPS recommendations, as of FY2015, expenses derived from operations with related parties that, due to a different qualification, do not generate an income or generate income that is exempt or subject to a tax rate under 10 percent, are not deductible.

Additionally, interest on hybrid financial instruments representing share capital of the issuer (e.g. non-voting shares, redeemable shares) and interest on profit-participating loans granted to group entities are characterized as dividends and could benefit from participation exemption.

The new CIT law also 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 (e.g. accounting recognition of the shares). The participation exemption does not apply to dividends that are characterized as a tax-deductible expense in the entity distributing the dividend.

Deferred settlement

On deferred settlement or payment by installments, income and/or gains are deemed to be obtained on a proportional basis as the payments are made, unless the entity decides to use the accrual method of accounting.

Transactions in which the consideration is received, in whole or in part, in a series of payments or a single late payment are deemed to be installment or deferred price transactions, provided that the period between delivery and the maturity of the last or only installment exceeds 1 year.

Other considerations

Concerns of the seller

Where a purchase of both shares and assets is contemplated, the seller's main concern is the reduction or elimination of the gain derived from the sale. Thus, the following factors should be taken into account:

- A major change in shareholding (see tax losses) and participation in the transferring company by the acquiring company may reduce the loss carry forward benefit if the target company has been inactive for any length of time.
- The date of acquisition is crucial (for real estate only where the seller is a legal entity and for all assets where the seller is an individual, provided certain requirements are met).

Company law and accounting

Spanish accounting legislation was adapted to European legislation by Law 16/2007, which was designed to reform commercial accounting rules and harmonize them with EU rules.

The General Accounting Plan was approved by the Royal Decree 1514/2007.

For accounting purposes, a business combination may be categorized as either an acquisition or an intragroup operation.

In essence, a combination is regarded as a merger where it affects a pooling of business interests (where one company's equity is exchanged for equity in another company) or where shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for their equity, with both sides receiving little or no consideration in the form of cash or other assets.

The acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration exceeds the aggregate of these values. Acquisition accounting principles also apply to purchases of trade and assets.

An important feature of Spanish company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. Interim dividends are allowed.

Article 273.3 of the Corporate Enterprises Law requires that dividends should not be paid unless the distributable reserves are at least equal to the R&D expenses recorded as assets.

Distribution of pre-acquisition retained earnings of the acquired company should be recorded as a reduction in the value of the participation acquired (for both accounting and tax purposes). In certain cases, even if the dividend is not recognized as taxable income, the purchaser could obtain a tax credit to avoid double taxation for the dividend received if enough evidence can be provided of the taxation borne by the seller on the sale of the target shares.

Finally, a common issue on transaction structuring arises from the provisions for financial assistance. Generally, it is illegal for a company to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares.

Law 3/2009 regulating structural modifications of commercial companies also deals with financial assistance. It stipulates that in the case of a merger between two or more companies, a report by an independent expert on the merger plan is required where any of the companies has incurred debt during the previous 3 years to acquire control over or essential assets from another company participating in the merger. The independent expert must pronounce on whether or not financial assistance has been provided.

According to the criteria of the Spanish accounting authorities, certain waivers of loans or conversions of loans into equity made in the context of a debt restructuring process could trigger accounting income for the borrower, which would be included in its taxable income.

Group relief/consolidation

Grouping of companies for tax purposes is possible provided the dominant company (which must be a resident entity in Spain, unless no Spanish entity meets the dominant company requirements) directly or indirectly holds at least 75 percent (70 percent for listed companies) of the stock of all companies of that group at the beginning of the year in which the tax-consolidation regime is to be applied. This participation must be maintained for the entire fiscal year in which the consolidation regime is applied.

Formerly, the group dominant entity had to be a Spanish entity. However, according to the new CIT law, Spanish sister entities with a non-Spanish parent (and Spanish subs indirectly owned) can now form a tax group.

Transfer pricing

The main rule governing transactions between associated parties is that the transactions should be carried out at prices that would have been agreed under normal market conditions between independent companies (i.e. arm's length price).

Dual residency

There are no advantages in Spain for a company with dual residency.

Foreign investments of a local target company

Generally, from an exchange control point of view, foreign investments are unregulated and can be freely made, although they must be declared to the foreign investments registry by filing the relevant forms.

Where the foreign participation in the Spanish company is higher than 50 percent, prior communication with the general directorate of foreign transactions is required when the foreign investor is a resident of a tax haven.

Comparison of asset and share purchases

Advantages of asset purchases

- The step-up in the assets acquired can be depreciated or amortized for tax purposes.
- No previous liabilities of the company are inherited, unless the acquisitions made by one or several persons or entities constitute a going concern (even in this case it is possible to request a certificate of tax liabilities from the tax authorities and limit the liabilities to those disclosed in the certificate).
- Only part of the business may be acquired.
- Where the selling company has tax losses, capital gains can be offset against the seller's tax losses, thereby effectively allowing for immediate use of the losses, with certain limitations.
- Not subject to VAT when a branch of activity is transferred.
- A profitable business can use its acquirer's tax losses.

Disadvantages of asset purchases

- The capital gain derived from the transfer is subject to CIT for the seller unless it arises as a consequence of a corporate reorganization protected by the neutrality tax regime.
- A higher capital outlay is usually involved (unless business debts are also assumed).
- Possible need to renegotiate supply, employment and technology agreements, and change stationery.
- Generally, benefit of any losses incurred by the target company remains with the target company.
- Tax liabilities are inherited when acquiring a business unit.

Advantages of share purchases

- Capital gains on a sale of shares by a Spanish company may benefit from participation exemption if certain requirements are met.
- May benefit from tax losses of the target company (with certain limitations).
- Lower capital outlay (purchase net assets only).
- May gain benefit of existing supply or technology contracts.
- Not subject to VAT or transfer tax (unless anti-avoidance rules apply where real estate is involved).

Disadvantages of share purchases

- Purchaser acquires unrealized tax liability for depreciation recovery on difference between market and tax book value of assets.
- Liable for any claims or previous liabilities of the entity.
- Losses incurred by any company in the acquirer's group in the years before the acquisition of the target cannot be offset against profits made by the target company unless a specific restructuring is performed.
- Less flexibility in funding options (requires debt pushdown strategies to offset interest expense with target's business profits).
- The affiliation privilege may not apply on dividends distributed from existing retained earnings.

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