tax notes international
Volume 73, Number 8 ■ February 24, 2014

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Spanish Tax Considerations for U.S. Investors

by Carlos Gabarró

Reprinted from *Tax Notes Int'l*, February 24, 2014, p. 719

taxanalysts® The experts' experts.℠

PRACTITIONERS' CORNER

Spanish Tax Considerations for U.S. Investors

by Carlos Gabarró

Carlos Gabarró is a tax partner with ALTALEX in Barcelona. E-mail: carlos.gabarro@altalex.es

Spain and the U.S. offer both tax challenges and opportunities for cross-border transactions. Special consideration is given to their strict tax systems and the sophistication of the tax administrations and authorities.

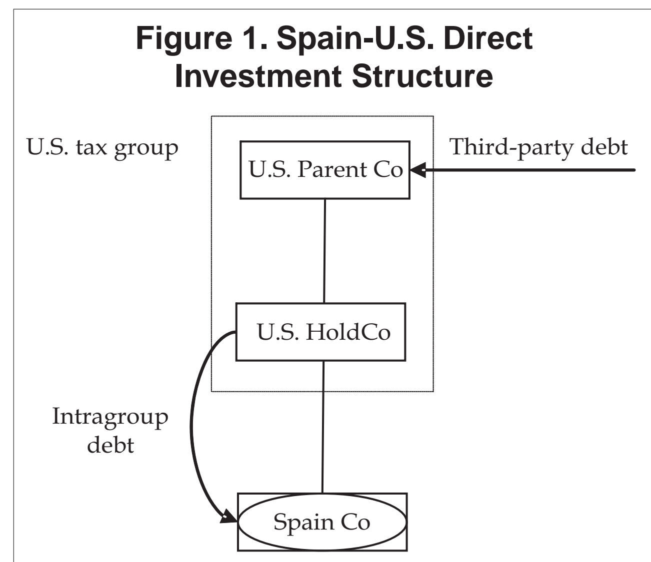
This article summarizes some cross-border tax matters to be considered by U.S. corporate investors already operating in Spain or willing to enter the Spanish market directly or by means of acquisitions, or just considering Spain as a holding jurisdiction from where to manage and control overseas operations.

U.S. Direct Investment Into Spain

U.S. corporate investors set up their business (or acquire an existing Spanish business) either as a direct investment into Spain or routed through a global or regional group holding company structure, typically set up in Europe. Tax treaties, U.S. tax deferral, foreign tax credits, and entity classification under check-the-box rules have an impact in this respect.

It is common to establish a Spanish entity as a Spanish private limited liability company (SL) to run a new Spanish business or acquire an existing one. A Spanish SL is an eligible entity for U.S. check-the-box purposes.

When setting up the business in Spain as a direct U.S. investment, financing would typically be provided as a contribution of equity and as debt in the Spanish company. The Spanish SL might be ''checked'' in the U.S. to be disregarded as a separate entity from its shareholder. A possible direct Spain-U.S. investment structure is illustrated in Figure 1.



The general Spanish corporate income tax rate is currently set at 30 percent. From a Spanish tax perspective, several matters must be considered when financing operations directly from the U.S. For example, because Spain uses the euro, currency exposures will be observed (foreign exchange gains and losses would be considered for Spanish tax purposes). For the interest expense to be deductible, debt will be granted for bona fide business reasons, terms and conditions will be established at arm's length, while specific interest limitation rules will be observed. Interest and dividend payments to a U.S. parent would generally be subject to a 10 percent withholding tax under the income tax treaty.

On January 14, 2013, the U.S. and Spain signed a protocol amending the current income tax treaty. Once

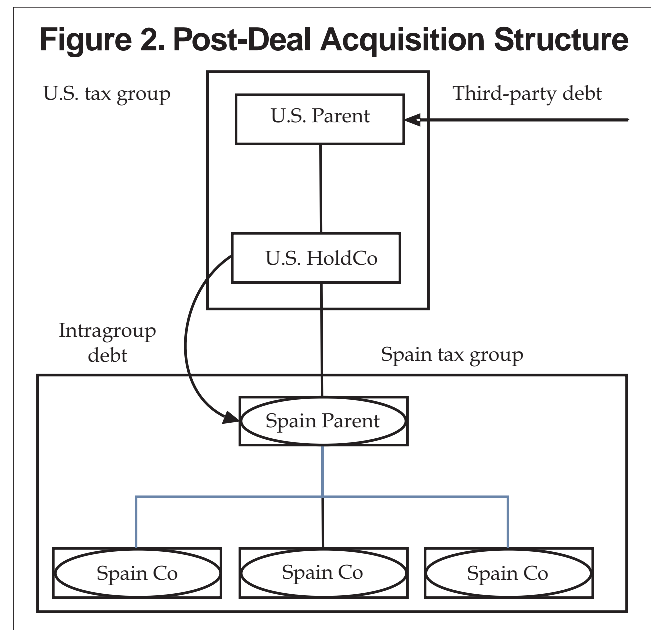
(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

in force, the amended treaty will provide for an exemption of withholding tax on dividends, interest, and royalties under certain conditions. Since the amended treaty will be aligned to current OECD standards, it will only be granting taxing rights on capital gains to the country of residence (except, in general, for the transfer or sale of real estate or of shares of companies predominantly holding real estate). The new protocol also contains a comprehensive limitation on benefits provision that is intended to ensure that only residents of the U.S. and Spain will enjoy the benefits of the treaty. It also provides for the full exchange of information between the competent authorities to facilitate the administration of each country's tax laws.

For a third-party acquisition through a Spanish company, similar financing comments as above apply. In an asset deal, a step-up in basis might be achieved (contrary to a pure intragroup acquisition, in which restrictions would apply). For a share deal in Spain, a tax group may be formed. Timing of formation of the tax group is worth considering, since the interest expense accrued before the tax group regime starts to apply could only be used on a stand-alone basis. In the share transaction, an asset step-up would only be achieved by merging upstream the target into the holding company. In this case, among other requirements, the sellers had to be subject to tax in Spain or in another EU member state (except if in a listed tax haven), and the merger must benefit from the application of the rollover tax relief regime.

The application of this special regime is conditioned on the merger pursuing sound business reasons such as the restructuring and rationalization of the activities of the entities intervening in the transaction, which must be carefully observed, reviewed, duly documented, and evidenced so that the special regime is not successfully challenged. The Spanish tax authorities play close attention to transactions under this regime. A direct U.S. post-share-deal acquisition structure is illustrated in Figure 2.

Figure 2. Post-Deal Acquisition Structure



U.S. Indirect Investment Into Spain

Multinational groups traditionally establish global or regional holding company structures to manage and control overseas operations. A holding company structure can result in operational and financial efficiencies, in particular when bundled with other business functions, including broader regional headquarters and management functions, group-shared services, financing, cash management, and intellectual property (IP) ownership and management. Reasons often cited for the formation of a global or regional holding company include:

- the desire to consolidate the group's current (and future) subsidiaries under one holding company structure for management and reporting purposes;
- the creation of a platform for future business acquisitions, joint ventures, and other business opportunities;
- to act as a gateway for growth and expanding business operations in new markets and regions;
- increased financial flexibility and the creation of an efficient vehicle for the redeployment of cash among foreign operations, thereby facilitating the use of internal funding of operations and expansion;
- improved treasury efficiency and financial risk management by permitting foreign cash, foreign currency receipts and disbursements, and intercompany loans and other transactions to be consolidated, netted, and managed within the holding and financing structure;
- facilitation of raising capital offshore, thereby enhancing the enterprise's capital structure;
- to better manage and exploit industrial and intellectual property; and
- facilitation of the preparation of a subconsolidation of the combined foreign operations of the company for financial reporting purposes.

Luxembourg, the Netherlands, and, to a lesser extent, other EU jurisdictions such as the U.K. or Spain are popular for the presence of holding companies of corporate groups from the U.S. and other countries. Each jurisdiction has its advantages and disadvantages. There is no doubt that in recent years Luxembourg has been very active in attracting U.S. groups not only to establish global holding structures but also to undertake overseas financing and IP management activities for large multinationals. The Netherlands has been a pioneer — a well-respected and traditional holding company jurisdiction. The U.K. is very active in attracting headquarters centers in Europe.

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

From a Spanish viewpoint, the EU parent company holding the shares of the Spanish subsidiaries must meet specific requirements so that dividends can be distributed free of Spanish withholding tax. In this respect, the tax authorities and Spanish courts follow a very restrictive approach when the EU parent company's majority of voting rights are, directly or indirectly, in the hands of non-EU residents. Careful planning and review must be undertaken in order to ensure the application of the dividend withholding tax exemption.

By the late 1990s Spain began to be the center of attention regarding its holding company regime, which was in force in 1996 but benefited from several improvements some years later. A full participation exemption regime coupled with the absence of Spanish taxation on distributions to the holding company's shareholders when meeting specific requirements has been one of the key reasons to consider the Spanish holding regime by the multinational investors.

Spanish Holding Company Regime

Spain provides a comprehensive participation exemption regime on foreign-source dividends and capital gains for multinational investors, access to EU directives, and 84 income tax treaties that follow the OECD model. Spain's most extensive treaty network is with Latin America.

Provided specific criteria are met, any Spanish entity subject to corporate taxation may opt for the Spanish holding company regime, known as Entidades de Tenencia de Valores Extranjeros (ETVE, or foreign securities holding company). Typically, the Spanish entity is established as a Spanish SL or, in some cases, even as a partnership subject to Spanish corporate taxation.

Many international tax practitioners understand the Spanish ETVE tax regime, but a summary of some of its key features is still worth outlining here.

ETVE Participation Exemption Requirements

Spain's Corporate Income Tax Law (CIT Law) provides a participation exemption regime that allows a company to apply a full tax exemption on dividends and capital gains from non-Spanish subsidiaries. Likewise, it also provides for a full exemption on income derived from a foreign permanent establishment (even a low-taxed branch duly availed of human and material resources in another country to which certain group activities are functionally attributed).

The CIT Law provides a special tax regime for ETVE holding companies that meet specific conditions, under which a zero-in, zero-out tax treatment for qualifying dividends and capital gains applies. In essence, a Spanish entity under ETVE tax status would allow distributing dividends free of Spanish withholding tax when derived from earnings generated out of foreign-source dividends and capital gains that have qualified for the full tax exemption regime on foreign subsidiaries (and income from non-Spanish PEs, as indicated in some binding tax rulings by the Spanish tax authorities if specific criteria are met).

Likewise, capital gains derived from the transfer of shares of the holding company would not be subject to Spanish tax if these are derived from:

- accumulated earnings in the ETVE that have qualified for participation exemption; or
- an increase in value attributable to non-Spanish subsidiaries (or PEs) that qualify for participation exemption.

For these purposes, the shareholder (actually, the recipient of the income) of the ETVE must not be a resident of a Spanish listed tax haven.

In order to benefit from the ETVE tax regime, the following requirements must be met:

- *Corporate purpose*: The corporate purpose must include the management and administration of foreign shareholdings through the appropriate human and material resources.
- *Minimum participation requirement*: The ETVE must hold a minimum shareholding of at least 5 percent either directly or indirectly of its foreign subsidiaries (this minimum participation requirement must be met at every tier of the holding structure). This threshold may be replaced by an acquisition cost of the foreign subsidiary's shares greater than €6 million (in this case, additional requirements must be met for multitier holding structures).
- *Minimum holding period*: The shareholding in non-Spanish subsidiaries in which the minimum participation requirement has been met must have been held for at least one year before the date on which dividends and capital gains eligible for the participation exemption regime are received. For dividends, this minimum holding period may be completed after the dividend distribution takes place. The period during which other members of the group (as defined) held the non-Spanish subsidiaries is also taken into account to calculate the holding period.
- *Subject-to-tax test*: Foreign subsidiaries held by the ETVE must have been subject to a tax identical or analogous in nature to the Spanish corporate income tax during the tax year in which the earnings being distributed were obtained. Companies that are resident in a Spanish-listed tax haven will not comply with this requirement unless the company is resident in an EU member state and provided it is incorporated for sound business reasons and it carries out an economic activity. Conversely, this test is considered to be met for subsidiaries resident in a country that has concluded an income tax treaty with Spain containing an exchange of information clause and that treaty could potentially be applied by the subsidiary.

(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

- *Business activity test*: Foreign subsidiaries held by the ETVE must derive at least 85 percent of their income from the performance of business activities conducted outside Spain. For sub-holding entities, the income obtained from their shareholdings (that is, dividends and capital gains) is considered to derive from business activities if the dividends and gains are sourced from lower-tier subsidiaries that meet the requirements of the participation exemption regime. Similarly, group financing entities are deemed to obtain income derived from business activities provided the ultimate borrowers are non-Spanish group entities that carry on a business activity. Note, however, that some interest from deposits in banks, bonds, and other portfolio income and gains may not be considered to derive from the conduct of a business activity.

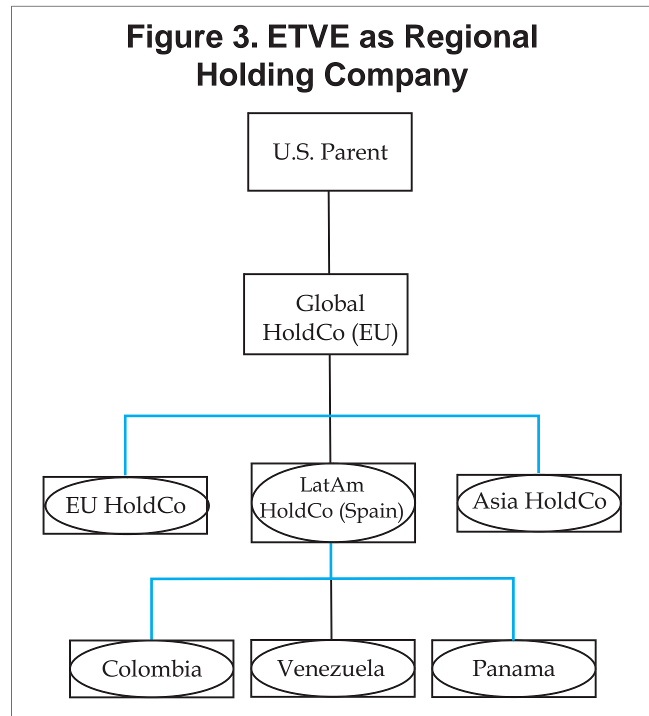
The business activity and the subject-to-tax requirements must be met by the foreign subsidiaries in all of the tax years during which the interest was held in order that capital gains received by the ETVE may completely benefit from the participation exemption tax regime.

If all of the above-mentioned conditions are met, dividends and capital gains derived from the foreign subsidiaries held by the ETVE will not be included in the Spanish ETVE tax base. Likewise, dividends distributed and gains obtained by the Spanish holding company shareholder would be free of Spanish taxation.

An ETVE holding structure for Latin America is illustrated in Figure 3.

Foreign Branch Income

A Spanish entity under ETVE status may also perform other operations either directly or through a branch. Income functionally attributable to a PE abroad that meets the subject-to-tax and business activity tests will be exempt at the ETVE level. Further, based on a reasonable interpretation of the Spanish tax authorities, earnings out of that tax-exempt income may also be distributed as a dividend by ETVE free of Spanish withholding tax as long as specific criteria are met. ◆



(C) Tax Analysts 2014. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.