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New Transfer Pricing provisions on the Spanish Corporate Income Tax

Please find below a summary of the main Spanish corporate income tax amendments that have taken place in relation to controlled transactions following the approval of the corporate income tax reform in Law 27/2014 of November 27, 2014.

1. Rules on determining related parties

- The new article 18 of the Corporate Income Tax Law has largely kept the rules in the previous wording of the law, with the following exceptions (all long called for):

  - the scenario in which an entity and the members or investors of another entity were treated as related parties where both entities belonged to the same group has disappeared;

  - another case no longer treated as a controlled transaction is the remuneration paid by an entity to its directors (both official directors and those acting as such) for their activities as such; and

  - both the former related party rules for nonresident entities with their permanent establishments in Spain[1] and those for entities belonging to a group taxed under the regime for groups of cooperative companies have also been removed.

- In step with the rules in Spain's neighboring countries, the necessary ownership interest for parties to be related has been raised to 25% where related-party status is defined by reference to the relationship between the entity and its members or investors, instead of the 5% (or 1% in the case of listed shares on a regulated market) set out in the former law.

2. Documentation obligations

- The Law now makes a general reference to proportionality and sufficiency principles in relation to the obligation to the transfer pricing documentation to be made available to the tax authorities.

  It fails to clarify, however, how those principles are put into practice or how they must be taken into account in the preparation of the documents by the taxpayer or in their examination by the inspectors, beyond any reference to them in the OECD transfer pricing

[1] Although the reference to this scenario, which was also set out in the Nonresident Income Tax Law has been kept in the new wording of this law (article 15.2).

Guidelines and the recommendations of the EU Joint Transfer Pricing Forum which the preamble to the Law provides as a source for interpretation, insofar as they do not contradict Spanish law.

- The option to elect simplified documentation rules has been broadened (implementing regulations have yet to be issued) in relation to related persons or entities with net revenues below €45 million (the previous limit was €10 million).

  The Law specifies, however, a number of transactions where these simplified rules do not apply, which are broadly: (i) transactions performed with related entities by personal income taxpayers in the course of an economic activity; (ii) share transfers, (iii) business transfers, (iv) transactions related to real estate, and (v) transactions involving intangible assets.

- Certain exceptions to the general documentation obligation have been moved to the Law, whereas before most of these exceptions were in the Regulations (articles 18 and 20). The specific transactions exempt from this obligation are:

  - Those carried out between entities in the same consolidated tax group.

  - Those performed with their members or with other entities in the same consolidated tax group by economic interest groupings and certain types of joint ventures (*uniones temporales de empresas*) (with exceptions for those electing the exemption rules for income obtained abroad through a permanent establishment).

  - Any carried out as part of share public offerings or tender offers.

  - Any performed with the same related person or entity, insofar as the amount of the aggregate consideration for all the transactions is not higher than €250,000, by reference to their market value.

  - The scenarios requiring specific documentation and the exception to this obligation where the aggregate consideration for all the transactions requiring documentation is under €250,000 have been eliminated.

  - Of the scenarios not requiring documentation which have been moved from the Regulations to the Law, the scenario related to transactions performed between credit institutions under institutional protection schemes approved by the Spanish Central Bank has been removed.

Broadly speaking, the amendments to the documentation obligations for controlled transactions follow the same principles as the existing rules and are very much in line with the Guidelines contained in the various projects carried out on this subject by the OECD and by the European Union.

It remains to be seen, however, whether the implementing regulations that are to come will include in Spanish law any of the latest recommendations in Action 13 of the BEPS Action Plan (although many are actually already in force) and particularly, whether the country by country report requirements will have any impact.

3. Transfer pricing methods

- The same five transfer pricing methods as were used in the past to support the arm's length price in controlled transactions have been retained.

- In line with the current wording of Chapters I through III of the OECD Guidelines, the hierarchy still in force in the previous law has been removed (priority to the comparable uncontrolled price, cost-plus or resale price methods). The most appropriate method must now be chosen on the basis of factors such as the characteristics of the controlled transaction, the availability of reliable information and the degree of comparability with uncontrolled transactions.

- Also drawn from the latest OECD recommendations (in both the Guidelines, in general terms, and those in other more specific documents, such as that relating to the amendment of Chapter VI on intangibles in the BEPS Action Plan), generally accepted pricing methods are now allowed to be used, insofar as they are consistent with the arm's length principle.

The update of the Spanish law in this point looks set to be beneficial, although in actual fact, flexibility in the application of both the methods and the use of certain pricing methodologies and practices had already become commonplace in determining the market value of controlled transactions.

4. Related-party transaction categories

- Concerning the intragroup services and cost sharing agreements intercompany transactions much part of the content has remained the same. Nevertheless, it has been removed the reference that established that the conditions mentioned therein are requirements for deductibility of expenses for both items.

  In relation to intragroup services, Spanish law is consistent with the Guidelines recently published in relation to with low value added products by the EU Joint Transfer Pricing Forum and the OECD as part of the BEPS Project (Action 10).

  In both cases, a number of issues are addressed which (broadly speaking) were already being applied in the analysis of this transaction category, such as for example, the categorization of costs, inability to deduct some of those costs (shareholder profit costs and duplicated costs).

  The Law makes no mention, however, of other elements that have been the subject of disputes in the past, such as the systems for reporting and documenting the services provided, or in relation to securing safe harbors with respect to the applicable margin on costs when determining their price[2].

[2] The OECD recommends a margin of between 2% and 5% in this respect, whereas the EU Forum talks about between 3% and 10% with a median of 5%.

- The requirements established in the Regulations to treat the agreed price as the arm's length value in cases of services provided by professional members (individuals) to a related entity have been moved to the Law, and a number of amendments have been added:

  - it is no longer required that the income to be recorded in the year before the deduction of the remuneration relating to all the member-professionals is positive;

  - the lower threshold for the remuneration of all the member-professionals has been lowered from 85% to 75% of income (before deduction of the remuneration of all the member-professionals in respect of their services provided);

  - certain limits have been changed relating the amount of the remuneration of the member-professionals, to allow, where any member-professionals breach the requirements, the others that do meet them to apply this safe harbor; and

  - the requirement to be one of the entities set out in article 101 (small-sized entities) for the taxpayer to be able to treat the agreed price as the market price in the cases of services provided by a professional member to a related entity.

- Moreover, although not specifically set out in the article of the Law on controlled transactions, it is worth mentioning the restriction established in article 15 (letter j) on the inability to deduct expenses relating to transactions performed with related persons or entities, which, as a result of a different tax characterization for them, do not generate income or generate exempt income or income subject to a nominal rate below 10 percent.

  Like other new additions, this change is drawn from the latest OECD BEPS projects, in particular Action 2 of the Action Plan (measures adopted to neutralize the effects of hybrid instruments).

5. Permanent establishments

- A new provision has been added requiring taxpayers with permanent establishments abroad to include in their tax bases the estimated income, calculated on an arm's length basis, that will be obtained on domestic transactions performed with these establishments, although on condition that this is allowed by an applicable tax treaty.

  To date, none of the treaties signed by Spain allow that option, although it may appear in the ones signed or renegotiated in the future.

- Consistently with the above, the Nonresident Income Tax Law also includes a new additional provision (six) which allows, for the purpose of determining the income of a permanent establishment located in Spain, the deduction of the estimated expenses (calculated on an arm's length basis) in respect of domestic transactions performed from their head office or with any of their permanent establishments located outside Spain, taking certain circumstances into account for these purposes, and again, insofar as it is permitted by a tax treaty.

The amendments to both taxes are designed to bring clarity to determining the tax base for "transactions" performed between permanent establishments and their head office or other parties, in line with the projects carried out in this respect by the OECD (particularly, that on the attribution of income to the permanent establishment, and to a letter extent, that resulting from Action 7 of the BEPS Plan).

6. Advance pricing arrangements with the tax authorities

- An important new provision has been added on retroactive effect of these arrangements. Whereas under the previous law these agreements could take effect for transactions in the tax period in which they were concluded, and to those in the previous period (insofar as the voluntary filing period for the tax had not ended), the new law provides that they also take effect in relation to transactions in all earlier tax periods, insofar as the tax authorities' right to determine the tax debt by issuing an assessment has become time-barred and there is no final assessment in relation to the transactions on which the request was made.

7. Secondary adjustment

- Following the Spanish Supreme Court's judgment in May regarding certain provisions on the Corporate Income Tax Regulations, the wording of article 21 bis, point 2, of the Corporate Income Tax Regulations has been included in the Law. This article relates to the treatment of the valuation differences in scenarios in which related parties are defined according to the relationship between the members or investors and the entity.

- A new option has been included allowing this secondary adjustment not to be made when the differences arising from the incorrect pricing on an arm's length basis of a given controlled transaction are restored. The Law refers in this respect to subsequent implementing regulations, and clarifies that this restoration will not determine the existence of income at the affected parties.

8. Procedure for reviewing the arm's length value

The amendments made in this connection do not materially alter the overall structure of the procedure for reviewing the arm's length value in controlled transactions, although there are some changes that need to be noted:

- The option to request an expert contradictory appraisal as a mechanism to determine the arm's length value has been removed, and a new rule has also been added preventing the use of this mechanism.

- The activities that the tax authorities can carry out have generally been broadened. Whereas the former law authorized the authorities to review that the transactions performed between related parties were priced at their arm's length, the new article 18.10 states that they also may review the nature of the transactions performed between related parties (not just their value).

  And consistently with this new provision, what were previously "valuation" adjustments in the Law are now simply denominated "adjustments".

  The above changes appear to be designed to enable the tax authorities to make adjustments to both the value and legal nature of the controlled transaction under review.

  Again, the influence of the BEPS Action Plan is apparent here, in particular concerning the recommendations on recharacterization and risks in Actions 9 and 10, although both have yet to be implemented by the OECD.

9. Infringement and penalty regime

Broadly speaking (and as the preamble to Law 27/2014 points out), the new legislation added on infringements and penalties is aimed at softening the penalty regime hitherto in force.

- The following defined infringements have been kept: (i) failure to provide documents or providing incomplete documents or false information, and (ii) where the arm's length value derived from the documents is not that reported for the relevant tax.

- The second case is only an infringement where adjustments are made by the tax authorities, whereas the first case is an infringement even without any adjustments by the tax authorities.

- Both infringements continue to be classed as serious.

- For the first infringement, in the absence of a valuation adjustment, a fixed monetary fine has been retained, although lowered to 1,000 euros for each omitted or false piece of data (from 1,500 euros) and 10,000 euros for each omitted or false set of data (from 15,000 euros), and the upper limits have been retained on the same terms as have been in place to date.

  For the second infringement (and for the first if there is a valuation adjustment), the Law has kept the proportional monetary fine of 15% of the amounts resulting from the adjustments, but the lower limit equal to double the fixed monetary fine has been removed (which was to be expected, as it no longer applies in this case).

- Broadly, all references to incompatibility with the penalties under article 191 et seq. of the General Taxation Law have been kept, along with those to the infringements under those articles not taking place if the documentation obligations are performed, to the compatibility with the penalties under article 203 and to the option of reducing them on the terms of article 188 of the General Taxation Law.

- Lastly, the most important amendment in this section relates to the arm's length value determined for corporate income tax, nonresident income tax or personal income tax purposes having no effect on other taxes, and vice versa.

10. Transactions performed with or by entities resident in tax havens

- The obligation to price and document transactions performed with persons or entities resident in tax havens has stayed, and the option to use the value agreed by the parties if a higher amount of tax results in Spain has been removed.

11. Reduction of the income obtained on certain intangible assets ("Patent Box")

- The wording in Law 14/2013 of September 27, 2013, has broadly been kept, with a few additions:

  - In the absence of any potential implementation regulations that might remove scenarios that could generate uncertainty over the determination of income, the new Law has done away with the presumption that 80 percent of the revenues from the

assignment is chargeable net income in cases where the assigned asset is not recognized on the balance sheet of the licensing entity.

- Due to the removal of the tax credit for reinvestment of extraordinary income, the reference to incompatibility with this tax credit has also disappeared.

Lastly, in the article relating to inclusions in the consolidated tax group regime, it has been clarified that the inclusion of revenues, costs or income relating to the reduction set out in article 23 of the Law will be made in the tax base of the tax group in the tax period in which they are considered to be realized with respect to third parties.

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