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TAX NEWS – ROYAL DECREE-LAW 12/2012

Royal Decree-Law 12/2012, March 30, 2012, introducing various tax and administrative measures aimed at reducing the budget deficit, was published in the Official State Gazette on March 31, 2012.

This Royal Decree-Law introduces some very specific and important measures mainly affecting the **corporate income tax** of large companies and sets out certain rules on the repatriation of unreported income or of cash held in low- or zero-taxation territories.

They are in line with earlier measures introduced by Royal Decree-Law 9/2011, which restricted the tax loss carryfowards large companies could offset; deferred the deduction of financial goodwill on acquisitions of companies in other countries; and pushed up the amount of corporate income tax prepayments.

These earlier measures have now been expanded by extending the deferral to other deductible goodwill, such as the goodwill on acquisitions of business or in certain merger transactions; by considerably curtailing the use of the tax benefit allowing unrestricted amortization or depreciation; by restricting the amount of borrowing costs that can be deducted; and by setting a minimum limit on corporate income tax prepayments, calculated on the basis of the profit recorded in the income statement.

The consequence, as a general rule, will be that the companies affected by these measures will see their tax bases rise considerably in the coming years, and it is on these tax bases that their corporate income tax liability will be calculated. The Royal Decree-Law has also temporarily brought down the ceiling on gross tax payable to be able to take corporate income tax credits, including the tax credit for reinvestment of extraordinary income, which hitherto had no restrictions at all.

An immediate impact is expected on tax revenues, as these temporary measures will apply to this year's first corporate income tax prepayment, due in the first twenty days of April 20, while the following ones are due in the first twenty days of October and of December 2012.

Another important headline is the creation of a **special 8% reduced rate** only for 2012, to be levied on dividends and foreign-source capital gains from territories with low or zero taxation, paid or arising until December 31, 2012, with the aim to attract income or profits generated abroad that had not been repatriated due to the high tax cost caused by distributing them in Spain.

In a step that takes further and implements the provision in criminal law that allows relief from criminal liability for voluntary disclosures made before the start of an audit or before an offence is reported or criminal complaint filed, it contains a **voluntary tax disclosure** mechanism allowing goods or rights not previously reported for personal income tax, corporate income tax and nonresident income tax purposes to be disclosed without any surcharges, interest or penalties.

Lastly, changes have also been made to the tax on tobacco products and the tax on increase in value of urban land which are not discussed in this Bulletin.

1. CORPORATE INCOME TAX

1.1 Borrowing costs. Restrictions on deduction

There has been a debate for some time now over whether to place a limit on the borrowing costs that can be deducted for corporate income tax purposes, how this should be done, and the parameters needing to be put in place, all on the basis of the latest legislative trends in Spain's neighboring countries. The new provisions, laid down for tax periods commencing on or after January 1, 2012, are as follows:

(a) Borrowing costs for the period are not deductible if they relate to **debts generated within the corporate group** incurred to acquire, from other entities in the same group, holdings in the capital or the equity of any type of entity, or to make contributions to the capital or the equity of other group entities.

The term "group" is defined, for these purposes, within the meaning of article 42 of the Commercial Code, regardless of the residence of the entities belonging to the group and of the obligation to prepare consolidated financial statements.

This restriction will not apply, however, (in other words, these borrowing costs *will* be deductible) if the taxpayer evidences the existence of valid economic reasons for performing these transactions, that is, as expressly mentioned in the preamble to the Royal Decree-Law, *if they are reasonable from an economic standpoint, as in cases of corporate restructuring within the group, a direct consequence of an acquisition from third parties, or cases where the acquired companies are genuinely managed from Spain.*

(b) **Net Borrowing costs over and above a ceiling equal to 30% of operating income for the period** are not deductible.

The *current* thin capitalization rule has been replaced with a general rule that places a limit equal to 30% of the operating income for the period on the deduction on borrowing costs. For these purposes:

- "Net borrowing costs" means the amount by which borrowing costs exceed the income derived from loans of company's funds to third parties in the tax period, not including any borrowing costs with group entities that are nondeductible under the rule described in point a) above.

- "Operating income" is obtained from the earnings from operations figure on the income statement for the year, determined by reference to the Commercial Code and other implementing accounting legislation, after: (i) subtracting the amortization and depreciation expense for fixed and other noncurrent assets; (ii) subtracting subsidies for nonfinancial fixed assets and others; (iii) subtracting any impairment loss on, and gains on disposals of, fixed and other noncurrent assets; and (iv) adding any financial income to be added from investments in equity instruments. This financial income only includes income from dividends or shares in income where either the taxpayer directly or indirectly holds at least 5% of the company concerned, or the acquisition cost of the holding in the company was higher than €6 million, unless the holding was acquired with funds borrowed from group entities and the related borrowing costs are not deductible.

This ceiling has been made subject to the following rules:

- Net borrowing costs for the tax period amounting up to €1 million, they will be deductible in all cases.

- In principle, the aim of this limit is to prevent excessive borrowing bringing the tax base down by a significant amount in any one period. That is why the portion that is not deducted in one period can be deducted in another period when operating income is higher or borrowing is lower. Thus:

  - Any net borrowing costs that have not been deducted in one period may be deducted in periods ending in the immediately following 18-year period, together with those for the period concerned, and subject to an aggregate ceiling of 30% of the period's operating income.

  - Where the period's net borrowing costs fall below the 30% ceiling, that shortfall will be factored in to calculate the ceiling for the tax periods ending in the immediately following successive 5 years.

- Entities that are taxed as part of a consolidated tax group must apply this ceiling in relation to the tax group as a whole, subject to the following rules:

  - The net borrowing costs of an entity that remained to be used when it joined the tax group will be deducted up to the ceiling of 30% of the operating income of the entity itself.

  - If one or more of the entities in the tax group leave the tax group or the tax group is dissolved, the group entities will acquire the right to deduct the expenses remaining to be used in proportion to their contribution to generating them.

- In the case of Economic Interest Groupings, the net borrowing costs that are not deductible will flow through to the partners and are not deductible by the grouping itself.

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- It is expressly stated that the above ceiling will not apply:

  - To entities that do not belong to a group within the meaning of article 42 of the Commercial Code, unless the borrowing costs from debts with individuals or entities that have a direct or indirect holding in the entity of at least 20%, or the borrowing costs from debts with entities in which the taxpayer has a direct or indirect holding of at least 20%, exceed 10% of the net borrowing costs.

  - To credit institutions. It is important to note that this does not mean all financial institutions, but rather only credit institutions, so this exemption does not apply, among others, to insurance and reinsurance companies, investment services companies, collective investment companies, managers of collective investment vehicles, of pension funds or of securitization vehicles, private equity firms and managers of private equity firms, reciprocal guarantee societies, etc.

    In the case of credit institutions that are taxed as part of a consolidated tax group jointly with other entities which are not, it is specified that the 30% ceiling must be calculated by reference to the operating income and the net borrowing costs of those other entities.

Lastly, these ceilings on the deduction of borrowing costs must be taken to coexist with the legislation on controlled transactions currently in force.

1.2 Unrestricted amortization and depreciation

In the corporate income tax legislation in force before the appearance of Royal Decree-Law 12/2012, there were two scenarios in which the unrestricted amortization and depreciation tax benefit could be applied:

- the scenario included in Spanish law by Law 4/2008, of December 23, 2008,

- and the scenario including companies that may apply the rules for enterprises of a reduced size.

This tax benefit consists of allowing taxpayers to accelerate the amortization or depreciation of certain assets acquired under certain circumstances, by making an adjustment to their corporate income tax base which does not have to be recognized for accounting purposes.

This incentive was introduced for the 2011 and 2012 periods by Royal Decree-Law 6/2010, and was subject to the enterprise keeping up its employment levels. Royal Decree-Law 13/2010, however, made an amendment to the rules on this special unrestricted amortization and depreciation system, by establishing that enterprises could amortize or depreciate the same type of assets but did not need to comply with requirement to keep up its employment levels.

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This affected assets handed over to the taxpayer in the tax periods commencing in 2011, 2012, 2013, 2014 and 2015, and also those handed over to the taxpayer after December 3, 2010 and before the first tax period commencing on or after January 1, 2011 (where the employment requirements under the previous system had not been met), in this last case only in the tax periods commencing on or after January 1, 2011. In the case of assets handed over before December 3, 2010, the initial system would apply, that is, the requirement to keep up employment levels would have to be met.

Both in the initial system and in the one amended by Royal Decree-Law 13/2010, special timing rules were established for assets acquired under contracts on the performance of construction projects or investment plans with a performance period in excess of two years.

Now, under Royal Decree-Law 12/2012:

- This unrestricted amortization and depreciation incentive is no longer available for new assets acquired on or after March 31, 2012. Accordingly, the five-year period envisaged for taking this tax benefit (between 2011 and 2015) has been reduced to the fiscal years that commenced in 2011 (it also applied in fiscal years 2009 and 2010 subject to the requirement to keep up employment levels).

- Taxpayers who made investments before March 31, 2012 and could take unrestricted amortization and depreciation and have amounts remaining to be amortized or depreciated, can continue to take this benefit (without having to reverse any amounts that they had amortized or depreciated at an earlier date).

  However, the taxpayers who made those investments in periods commencing in 2012 and 2013 can take accelerated amortization or depreciation for the assets, subject to a ceiling of:

  - 40% of the tax base before the amortization or depreciation and before the offset of tax loss carryforwards for taxpayers subject to the wording in Royal Decree-Law 6/2010.

  - 20% of the tax base before the amortization or depreciation and before the offset of tax loss carryforwards for taxpayers subject to the wording in Royal Decree-Law 13/2010.

  Where the taxpayers also have amounts remaining to be amortized or depreciated on the terms indicated in the preceding two paragraphs, they may take the amortization or depreciation subject to the following rules:

  - The 40% ceiling may be applied until the outstanding amounts, generated under Royal Decree-Law 6/2010, have been used up.

  - Once these amounts have been used up, taxpayers may take in the same tax period the outstanding amounts generated under Royal Decree-Law 13/2010 up to the limit of the difference between the 20% ceiling and the amounts already taken in the same tax period.

The ceilings will apply to investments in progress made until March 31, 2012, which relate to new assets commissioned under contracts for the performance of construction projects or investment plans which, in both cases, require more than two years to complete between the commission date or start of the investment and when the assets are handed over or brought into operation, where those investments qualified for the unrestricted amortization and depreciation system prior to the entry into force of Royal Decree-Law 12/2012.

This restriction on unrestricted amortization or depreciation in 2012 and 2013 for assets acquired before March 31, 2012 which did qualify for the tax benefit does not apply to enterprises which, on making the investment concerned, meet the requirements in article 108.1 of the revised Corporate Income Tax Law (on the special rules for **enterprises of a reduced size**). Therefore, these companies may continue to take unrestricted amortization or depreciation for these assets.

It must be remembered also that **enterprises of a reduced size** have their own unrestricted amortization or depreciation system for new assets (which has not been changed) where they increase employment levels (in the 24 months following the start date of the period in which the assets are brought into operation, with respect to the average headcount of the previous 12 months), provided that the increase is maintained for at least a further 24 months. In any event, the maximum investment that qualifies for this benefit allowing unrestricted amortization or depreciation will be the result of multiplying the increase in headcount by €120,000 (calculated with 2 decimals).

1.3 Goodwill on business acquisitions or on mergers

Royal Decree-Law 9/2011 lowered from 5% to 1% the maximum amount taxpayers can deduct in respect of financial goodwill on acquisitions of shares in nonresident entities (article 12.5 of the Corporate Income Tax Law) with effect for fiscal years commencing in 2011, 2012 and 2013.

Now, this new legislation has also lowered from 5% to 1% the maximum amount taxpayers can deduct in respect of financial goodwill on acquisitions of businesses (article 12.6) and on corporate restructuring transactions (article 89), with effect for fiscal years commencing in 2012 and 2013.

1.4 Income from holdings in nonresident entities. Dividends and gains

Two significant new provisions have been introduced in relation to dividends and other income from holdings in nonresident entities:

- The first provision is aimed basically at relaxing the exemption requirements applicable to gains from transfers of investments in nonresident entities, by allowing the exemption to be taken for gains deriving of periods when the requirements for the exemption are met, even if the requirements are or were not met in other periods.

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- The second provision is aimed at encouraging the repatriation of income from business activities which was obtained outside Spain by nonresident investee companies residing in zero-taxation countries and is therefore not exempt in Spain.

1.4.1 Gains from transfers of holdings in nonresident entities. Proportional exemption

Under the current legislation, gains obtained as a result of transfers of investments in non Spanish resident entities are exempt in Spain where certain requirements are met throughout the entire period in which the transferred holding was owned.

Taxpayers could be prevented from taking this exemption if the requirement had not been met in any particular period. This approach has now been changed and the exemption will apply in proportion to the years in which the requirements were effectively met. Detailed provisions are set out on how this rule works.

1.4.2 Special levy on foreign-source dividends and gains from transfers of nonresident entities

A special levy on foreign-source gains has been brought into effect to allow the repatriation of dividends or the transfer of shares, relating to nonresident entities which, despite meeting the requirements of article 21.1.a) and .c) of the Corporate Income Tax Law (i.e. a holding of at least 5% owned uninterruptedly for one year and income derived from performance of business activities abroad), do not meet the requirement in article 21.1.b) of the same law (i.e. where the investee company has not been taxed in respect of a foreign tax that is identical or similar to Spanish corporate income tax in the year in which the income being distributed or shared was obtained, and does not reside in a country with which Spain had signed a tax treaty containing an exchange of information clause).

The taxpayer is given the option, when repatriating these gains, to have them taxed under the standard corporate income tax rules or, alternatively, to apply this special levy.

The special levy may be applied to dividends, or shares in the income, of non Spanish resident entities and which are paid or arise before December 31, 2012, where the following requirements are met:

- The percentage held directly or indirectly and uninterruptedly for a year (before or after the distribution of the dividend) by the Spanish entity in the nonresident entity's capital or equity must be at least 5%.

- The income obtained by the nonresident entity must originate from business activities performed abroad (on the terms of article 21.c) of the Corporate Income Tax Law).

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This requirement may be determined for each entity, held directly or indirectly, by reference to the aggregate of all revenues obtained during the period in which the holding was owned.

This levy may also be applied to gains from the transfer of securities representing the equity of non Spanish resident entities that meet the holding requirement on the date on which the transfer takes place and where the requirement that the income originate from business activities abroad is met for all the years in which holding was owned, provided that the transfer takes place in 2012.

The rate for the special levy will be 8% and the tax base will be, in all cases:

1. The gross amount of the dividends or shares in income paid or accrued, without being able to deduct for tax purposes the impairment loss on the holding that may arise from the distribution of the income subject to this special levy.

2. The gain obtained on the transfer of the holding, as well as from the reversal of any value adjustment made to the transferred holding, which was treated as tax-deductible while the holding was owned.

In this case, however, the portion of the tax base that relates to any value adjustment that was treated as tax-deductible while the holding was owned, will be taxed at the tax rate applicable to the taxpayer.

The rules for accrual of the levy are as follows:

- The levy on dividends from, or shares in the income of, non Spanish resident entities will accrue on the date of the resolution to distribute income by the shareholders' meeting, or equivalent body.

- In the case of a transfer of securities representing the equity of non Spanish resident entities, the special levy will accrue on the date on which the transfer takes place.

The special levy must be self-assessed and paid over within a period of 25 calendar days after the date of accrual. However, if at the beginning of this period the Ministerial Order establishing the related tax return form has not been approved, the return will be filed within a period of 25 calendar days after the date the Order comes into force.

1.5 Tax credits. Reduction in the ceiling on tax payable

The amendments in relation to tax credits aimed at encouraging certain activities have centered on reducing the current aggregate ceiling on gross tax payable for determining the maximum amount for tax credits which is applicable in the tax periods commencing in 2012 and 2013.

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Although it would appear that at some point they were considering reducing or eliminating certain tax credits, they ultimately decided to keep the current tax credit system, while only placing a restriction on the total amount that may be taken according to the gross tax payable obtained by the company.

The amendments that have been made concern the following:

- A reduction from 35% to 25% regarding the percentage of the gross tax payable (less domestic and international double taxation tax credits and tax reductions) which cannot be exceeded when taking the tax credits under Chapter IV of Title VI of the Corporate Income Tax Law

- The increased ceiling of 60% has been reduced to 50% for cases where the amount of the tax credit for research, development, and technological innovation that relates to expenses incurred and investments made in the tax period itself exceeds 10% of the gross tax payable (less domestic and international double taxation tax credits and tax reductions).

- These ceilings will also apply to the tax credit for reinvestment of extraordinary income.

This reduction in the ceiling applicable to tax credits is only intended to produce a timing effect, and so to compensate the reduction, the period in which the already reported tax credit may be taken has been extended:

- The standard period has been raised from the immediately following successive 10 years to 15 years.

- The period for taking tax credits for research, development and technological innovation activities has been raised from the immediately following successive 15 years to 18 years.

This last change in the tax credit system has been introduced for an indefinite term, and also applies to tax credits remaining to be used at the beginning of the first tax period that commenced on or after January 1, 2012.

The tax credit for donations under Law 49/2002 has not been affected by these changes, given that this law establishes its own ceiling for the tax credit, whereby the tax credit base cannot be more than 10% of the tax base for the tax period. Any amounts over and above that ceiling may be used in the tax periods ending in the immediately following successive 10 years.

1.6 Corporate income tax prepayments

Royal Decree-Law 9/2011 increased the percentage to be used to calculate corporate income tax prepayments under the method which was based on the tax base for the period consisting of the first 3, 9 or 11 months of each year. It provided that if the net revenues of the entity in those twelve months of the previous year are (i) at least €20 million, but lower than €60 million, the percentage for the corporate income tax prepayments will be

calculated by multiplying the tax rate by 8/10 and rounding down; or (ii) if they are at least €60 million, the applicable percentage will calculated by multiplying the tax rate by 9/10 and rounding down.

This amendment first applied to the corporate income tax prepayments that should have been made in October 2011.

The new rule now is that a minimum amount applies to enterprises whose net revenues in the twelve months prior to the date on which the tax periods commence in the year 2012 or 2013 are at least €20 million, equal to 8% of the positive income figure recorded in the income statement for the first 3, 9, or 11 months of each calendar year, less any tax loss carryforwards (subject to the restriction on the offset of tax loss carryforwards established in Royal Decree-Law 9/2011).

The minimum percentage will be 4%, however, for the entities referred to above at which at least 85% of their revenues from the first 3, 9 or 11 months of each calendar year, relate to income that qualifies for the exemption established in articles 21 ("foreign-source dividends and gains") and 22 ("income obtained abroad through a permanent establishment") or the tax credit under article 30.2 ("domestic-source dividends and gains") of the Corporate Income Tax Law.

Regardless of the above, **for the split payment which falls due in the first 20 days of April, the percentages will be 4% and 2% respectively**, and the restriction on the deductibility of borrowing costs included in the Royal Decree-Law discussed in point 1.1.b.) above will not apply to this payment.

Although the legislation does not actually say so, we are assuming that this restriction also applies to tax groups, given that it refers to "taxpayers". In any event, it will fall to the tax authorities to clarify whether the base for this restriction is the profit in the consolidated income statement for the entities in the tax group or whether the base must be calculated under other rules, given that in this case there are no provisions on an income statement in the Commercial Code or other legislation implementing it.

2. VOLUNTARY DISCLOSURE OF UNREPORTED ASSETS – SPECIAL TAX RETURN

This new legislation allows taxpayers to disclose voluntarily any assets or rights that do not derive from income reported for personal income tax, corporate income tax and nonresident income tax purposes, by filing a special tax return.

The voluntary disclosure will be carried out by paying over 10% of the amount or acquisition cost of the assets or rights being disclosed, without any penalties, interest or surcharges for late filing and payment falling due. The amount that is reported will be treated as "reported income" for the purposes of the three taxes mentioned above.

The following points must be highlighted on the subject of this special return:

- The assets and rights that may be disclosed are those which the taxpayer owned before the end of the last tax period for which the filing deadline ended before March 30, 2012 (entry into force of the Royal Decree-Law).

- For the purposes of personal income tax, corporate income tax and nonresident income tax with a permanent establishment (where the fiscal year is the calendar year), it therefore covers assets and rights owned as of December 31, 2010. In the case of nonresident income taxpayers without a permanent establishment, it will be necessary to refer to each type of income, given that in this case there is a charge, as a general rule, for each time income was obtained.

- The special return must include a breakdown allowing the disclosed assets or rights to be identified, which will allow greater control of those assets and rights both for audits of the voluntary disclosures made and for future tax returns in relation to those assets, while also allowing control of undisclosed assets where the intention is to report them at another time.

- This special return may not be filed for taxes and periods reported after the commencement of tax inspection and audit proceedings by the tax authorities in relation to those taxes and periods.

The experience gained in voluntary disclosure programs in recent years made it advisable to strengthen the protection provided for both the tax authorities and taxpayers. Article 180 of the General Taxation Law provides that where the tax authorities consider that a tax infringement may constitute an offense against public finances, they must file the related report with the competent court or refer the proceeding to the public prosecutor’s office, and not continue with the administrative proceeding, which stops until the court hands down a final judgment, the proceedings are dismissed or struck out, or the proceeding is returned by the public prosecutor’s office.

Now it has been added that if the tax authorities consider that the taxpayer has disclosed its tax status (which entails recognizing and paying the tax debt in full) before the commencement of inspection or audit proceedings, the taxpayer will be relieved of any criminal liability even if the infringement could have constituted an offense against public finances at the time, and the tax authorities may continue the administrative proceeding without filing a report with the court or the public prosecutor’s office.

The new special return raises certain doubts, especially because it only covers three taxes, and not others such as wealth tax, inheritance and gift tax or transfer tax and stamp duty (regional taxes) or VAT. It must be taken into account that the rules on notifying the other tax authorities of the information that the taxpayer supplies to the state tax authorities may mean that the special return requires the taxpayer to simultaneously disclose any debts that may exist in respect of those other taxes.

Other points to be considered are:

- The special return covers, generally speaking, assets or rights owned as of December 31, 2010 rather than those owned as of December 30, 2011, and therefore the return for income and gains in 2011 will not in principle be covered by the special return.

- The base for the tax payment is calculated by reference to the amount or acquisition cost of the assets or rights, and there are no provisions allowing for debts to be deducted. The voluntary disclosure of the assets or rights at their amount or acquisition cost may pose particular difficulties if (i) the market value of the acquired assets has fallen substantially with respect to their cost, given that the 10% levy may be a much higher rate on the market value; or if (ii) the current amount of the disclosed accounts is lower than the original amount, given that a potential review of the movements in the accounts could lead to an assessment of the amount used or spent at the ordinary tax rates and with the imposition of interest, surcharges or penalties.

- It also appears that tax debts for reasons other than holding unreported assets cannot be regularized in this manner.

- The Royal Decree-Law does not clarify the treatment given to cases where the unreported assets are held through trusts, fiduciary arrangements, foundations or companies in low- or zero-taxation countries.

- In any event, the special voluntary disclosure program should be welcomed for several reasons: the 10% cost is moderate; it does not require the repatriation of capital or its investment in qualified assets; the voluntary disclosure fully releases the taxpayer from administrative and criminal penalties; and the taxpayer remains able to use the ordinary disclosure procedure.

Voluntary disclosures must be made before November 30, 2012. In their public presentation of Royal Decree-Law 12/2012, the government stressed that they would step up their pursuit of unreported income after this date has passed.

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