

Urgent memorandum on the new measures relating to deferred tax assets contained in Royal Decree-Law 14/2013

1. Introduction

Within the set of measures adopted by Royal-Decree-law 14/2013, one of the most-awaited issues was the regulation of deferred tax assets ("DTA").

Those measures are contained in Final Provision 2 of the Royal Decree-law amending the Revised Corporate Income Tax Law ("TRLIS"), which are the subject-matter of this memorandum.

Basically, the new legislation approved states that certain temporary differences deriving from bad debts and pensions will receive a special treatment as regards their inclusion in the tax base, with retroactive effects for tax periods commencing on or after January 1, 2011. Moreover, for tax periods commencing on or after January 1, 2014, the timing differences which, after taking into account the aforementioned rules, cannot be used in certain circumstances (either because the taxpayer incurs accounting losses or because it is liquidated or has an insolvency order against it) can be "converted" into current credits against the tax authorities (which can be cash-settled or offset against other current tax debts, at the taxpayer's option). Lastly, the provision establishes that after certain periods have elapsed without being able to use those tax assets, they can be exchanged for public debt securities.

2. Tax measures

2.1 Measures taking effect for fiscal years commencing on or after January 1, 2011: special timing for Corporate Income Tax deduction regarding certain adjustments

2.1.1 New timing for CIT deduction in individual tax return

Through the inclusion of a new paragraph 13, in article 19 of the TRLIS, a new timing allocation for CIT deduction is established, according to which certain temporary differences are not "converted" into tax losses.

Specifically, according to this rule, certain expenses recorded for impairment, as well as other provisions or contributions to employee welfare systems or pension schemes and, as the case may be, provisions for early retirement ("*prejubilación*") that have been considered nondeductible expenses and, therefore, have generated a DTA, will be deemed deductible in the fiscal year in which they are deductible according to the applicable CIT rule but subject to the limit of the positive tax base of that fiscal year (without including the amount of the reversal of that adjustment and before the offset of tax losses of prior years). In other words, not the entire amount of the adjustment will be reversed for tax purposes but only the portion that does not exceed the limit mentioned, so that the timing difference generated in the past is not "converted" into tax losses.

The provisions to which this new limit on reversal will apply are the following:

- Provisions for impairment of credits or other assets deriving from bad debt of parties not related to the taxpayer and which are not subject to the rule established in article 12.2.a) TRLIS (rule which determines the nondeductibility of bad debt provisions where fewer than six months have elapsed since the obligation matured).
- Provisions or contributions to employee welfare systems or pension schemes and, as the case may be, provisions for early retirement, that have not been deductible by application of articles 13.1.b) or 14.1.f) of the TRLIS.

The amount of the reversal of the adjustment, which is not included in the tax base by application of the aforementioned limit, will be included in the tax base of the following fiscal years, although this same special rule will continue to apply to the amounts outstanding reversal. In order to determine which timing adjustments should be reversed first for tax purposes, the provision establishes the FIFO method, that is, the first amounts to be included are those relating to provisions recorded in the oldest tax periods.

It should be noted that the new rules are approved retroactively (for fiscal years commencing on or after January 1, 2011), although the law does not establish the formal procedure to be carried out in order to apply the new rule to fiscal years 2011 and 2012, which issue will have to be clarified or implemented in the short term.

2.1.2 *New timing for CIT deduction in consolidated tax return*

The Royal Decree-law includes a provision expressly regulating the new timing allocation rule for consolidated tax purposes.

In this regard, three rules are established in the new Additional Provision 21 of the TRLIS.

The first rule states that in order to determine the prior consolidated tax base (which is that formed by the sum of individual tax bases "prior" to eliminations and incorporations), the provisions regulated by the new article 19.13 TRLIS and the offset of tax losses shall be excluded.

Once the prior consolidated tax base is determined, with the exclusions mentioned above, the taxpayer shall proceed to determine the inclusion (through negative adjustments) of the provisions regulated in article 19.13 which may be included in that tax base before the offset of the tax group's tax losses. Therefore, the credits for the group's tax losses (i.e. NOLs) will be used by the tax group after the adjustments established in article 19.13 TRLIS have been included.

The second rule provides that where an entity joins a tax group, any outstanding adjustments (i.e., those generated before that entity joins the group) can be included in the group's tax base. The use of these DTAs generated outside of the group will be limited to the positive amount of the individual tax base of the entity, without considering the effect of the reversal of those adjustments and without taking into account the offset of its individual tax losses (also generated outside the group). When calculating this limit applicable to the DTAs generated outside of the consolidated tax regime, any dividends with the right to a total tax credit for domestic double taxation (pursuant to article 30.2 TRLIS) taken by the entity in its individual tax base shall be excluded.

Lastly, in case of forfeiture or extinguishment of the tax group, a system for apportionment (individualization) of the adjustments pending reversal is established. In this regard, pursuant to the law, the provisions mentioned in article 19.13 which the group has not been able to deduct in the consolidated tax base by application of the limits described above will be attributed to the entities according to a proportional method, taking into account which entities have contributed to them.

2.2 Conversion of certain DTAs into credits against the tax authorities

The above rules on the timing for CIT deduction of certain timing differences are supplemented by a closing rule that permits considering that the DTAs of the same nature as those which are subject to these special rules "do not depend on the performance (i.e. existence of future profits) of the entity that generated them" and can be converted into current credits against the tax authorities or can be exchanged for public debt securities, as the case may be, in certain scenarios.

2.2.1 Assets that may be converted

This measure establishes that, for the tax periods commencing on or after January 1 2014, the DTAs relating to adjustments for the provisions mentioned in article 19.13 (provisions for impairment of credits or assets derived from bad debts, provisions and contributions to employee welfare systems or pension schemes and, as the case may be, provisions for early retirement) will be converted into a credit against the tax authorities in any of the following circumstances:

- Where the taxpayer recognizes accounting losses in its financial statements (audited and approved by the competent body). In this case, the amount to be converted will be the result of applying the percentage entailed by the accounting losses with respect to the capital and reserves, to the total DTAs that qualify for conversion.
- Where the entity is subject to liquidation or court-ordered insolvency (i.e. bankruptcy).

Moreover, pursuant to this rule, the DTAs relating to tax losses (i.e. NOLs) generated as a consequence of including in the tax base, as of the first tax period commencing in 2014, the reversal of the adjustments for the aforementioned provisions (for bad debt and pensions), will also be converted into current credits against the tax authorities.

2.2.2 Time of the conversion

The tax assets in question will be converted into a current credit against the tax authorities at the time of filing of the corporate income tax return for the tax period in which the circumstances giving rise to the conversion (accounting losses, liquidation or court-ordered insolvency) take place.

2.2.3 Options for the conversion

The DTAs may be converted into a credit against the tax authorities, at the taxpayer's option, either (i) through their cash-payment by the tax authorities, or (ii) through the offset against other current tax liabilities with the State Tax Authorities which the taxpayer itself generates as of the time of conversion.

The procedure and period for offset or cash-payment shall be established through regulations.

2.2.4 Exchange for government debt securities

For cases in which prior conversion does not apply (because the entity does not incur accounting losses or has not entered liquidation or court-ordered insolvency), and provided that a certain period has elapsed without the DTAs to which this section refers being used or, as the case may be, converted into a current credit against the tax authorities, those assets may be exchanged for government debt securities.

The elapse of the period necessary for the potential exchange of the DTAs for government debt securities will be computed as follows:

- For the DTAs recognized after the entry into force of this provision, the exchange will be possible after the elapse of the period for offsetting tax losses (i.e. 18 years) established in the TRLIS to be computed as from the accounting recognition of these tax assets.
- For the DTAs recognized before that entry into force, tax losses offsetting period needed for the DTAs to be exchangeable for government debt securities will be computed from the date of entry into force of the Royal Decree-law (i.e. December 1, 2013).

The details about the procedure and period for exchanging the DTAs for government debt securities shall be established by regulations.