

Royal Decree-Law 15/2014, of December 20, 2014, amending the Canary Islands Economic and Tax Regime

On December 20, 2014, the Official State Gazette published Royal Decree-Law 15/2014, of December 20, 2014, amending the Canary Islands Economic and Tax Regime (the "REF"), which amends Law 19/94, amending the REF.

Law 19/1994 regulates myriad tax incentives, applicable to both direct and indirect taxes, which are deemed to be state aid in accordance with EU law.

Consequently, their application must be brought into line with EU law. The former term of validity of these incentives was until December 31, 2013, in keeping with that of the map of regional state aid approved for Spain for the 2007-2013 period.

Given the delay in the approval of the Guidelines on regional state aid for 2014-2020 and of Commission Regulation (EU) No. 651/2014 of 17 June 2014, declaring certain categories of aid compatible with the internal market in application of articles 107 and 108 of the Treaty, commonly known as the General Block Exemption Regulation, Spain requested an extension of the validity of the incentives to 2014. This extension was granted by the Commission Decision of December 17, 2013.

When the extension expired, the REF legislation had to be amended again for the 2015-2020 period to bring it into line with the changes that arose from the negotiations conducted with the EU authorities. In a very big change of circumstances, as a result of the new approach by the authorities in relation to state aid, the system of notification and subsequent authorization was left behind and replaced with a mechanism for bringing all of the incentives included in the REF into line with the General Block Exemption Regulation.

This royal-decree-law takes the form of a single article that amends several provisions of Law 19/194 on the Canary Islands REF, making myriad changes with an impact on the rules on the Reserve for investments in the Canary Islands and on the Canary Islands Special Zone, in addition to introducing a tax credit for investments in West Africa and for advertising and publicity expenses.

No changes are made, however, to the rules on tax credits for increased investments in the Canary Islands, contained in Law 20/1991, amending the tax aspects of the Canary Islands Economic and Tax Regime, nor in particular to the rules on the tax credit for investments in property, plant and equipment.

Since prior EU authorization is no longer mandatory, the necessary mechanisms have been included to monitor its future compliance with the intensity ceilings and conditions applicable to the aid as contained in the General Block Exemption Regulation.

Lastly, the government is given authority to issue, within the scope of its powers, the regulations required to implement the royal decree-law; this will be necessary for many of the aspects contained in the royal decree-law.

In this Commentary, we examine the changes which are introduced by the royal decree-law in the legislation in force until December 31, 2014 and which will apply to fiscal years commencing on or after January 1, 2015.

1. Reserve for investments in the Canary Islands (the “RIC”)

1.1 Determination of income eligible for the RIC

The basic rules for determining the income that can give rise to a provision to the RIC are kept intact, with two new features:

- Gains on the transfer of assets not used in economic activities are also included, on the terms that will be determined by regulations.
- Gains on the transfer of assets where the acquisition of the assets constituted a use of the RIC are excluded.

1.2 Use of the RIC. New cases of eligible investments and other changes

The royal decree-law basically maintains the former system in relation to reinvestment options, and introduces the following new changes in relation to the options for using the reserve for investment commitments:

1. Creation of jobs that do not have to be linked to an initial investment, as hitherto required (which takes place when an establishment is created or expanded or its production process is diversified or substantially transformed).

Accordingly, amounts in the RIC can be used for the creation of jobs which takes place in the tax period even if they are not linked to an initial investment, subject to a limit of 50% of the provisions made by the taxpayer to the reserve in the tax period.

The creation of jobs will be determined by the increase in the taxpayer’s total average headcount in the period compared with the average headcount from the preceding 12 months, provided that the increase is maintained for five years, except where taxpayers meet the conditions laid down in article 101 of Corporate Income Tax Law 27/2014, of November 27, 2014 (regime for enterprises of a reduced size) in the tax period in which the income out of which the reserve is recorded is obtained, who must maintain the increase for three years.

The use of the reserve will be considered to have occurred only in the first two years after the increase in the headcount took place and will be computed, in each tax period, at an amount equal to the average cost of the gross salaries and the mandatory social security contributions that relate to the increase. For these purposes, this average cost may be treated as a use of the reserve up to a ceiling of €36,000 per worker.

2. Shares issued by entities in the Canary Islands Special Zone (the “ZEC”) as a result of their formation or capital increases, provided that the requirements and conditions necessary to consider that the entity is making an initial investment, and those necessary to apply the ZEC regime, are met.

As a new feature, the minimum limit existing in the former legislation, amounting to €750,000, is removed and the following exceptions and conditions are added:

- The amount of the share issue or capital increase allocated to use of the RIC cannot be used for compliance with the minimum investment requirements imposed on ZEC entities.
- The person or entity subscribing to the shares issued may not transfer or loan to third parties the assets used in their own business activities, and existing in the year preceding the subscription, in that year or in the following four years, unless their useful life has ended and they are replaced or unless this takes place in transactions performed in the normal course of business by taxpayers who engage, through an economic operation, in the leasing or loaning of property, plant and equipment assets to third parties for their use, provided that they are not directly or indirectly related to the lessees or borrowers of the assets, within the meaning of article 18.2 of Corporate Income Tax Law 27/2014, of November 27, 2014, and these are not finance lease transactions. Under no circumstances may the person or entity transfer or loan these assets to the ZEC entity in which they are subscribing to shares or to any another person related to that ZEC entity on the above terms.
- The person or entity subscribing to the issued shares may not reduce their total average headcount, existing in the year preceding the subscription, in the following four years. The total average headcount of the enterprise will be calculated by reference to the people employed, within the meaning of the labor and employment legislation, taking into account the working hours in their contracts compared with the full-time working hours.
- Any financial instrument issued by financial institutions, provided that the funds raised for the purpose of using the reserve are allocated to the funding, in the Canary Islands, of private projects insofar as investments in those projects are eligible for use of the RIC according to the general requirements laid down in this piece of legislation, provided that the share issues are supervised by the Canary Islands government, and are accompanied by a binding report from the State Tax Agency, on the terms that will be determined by regulations.

For these purposes, a taxpayer using the RIC must give verifiable notification to the financial institution of the amount to be used and the date it must be used by. The financial institution will in turn give verifiable notification to the taxpayer of the investments made and of their date. The investments made will be deemed to have been funded in the order in which the actual payment for them took place. In the case of payments made on the same date, they will be deemed to contribute proportionally to the funding of the investment.

Investments made under this scenario will not trigger the application of any other tax relief, except for that provided for in article 25 of Law 19/94, on the Canary Islands REF, relating to indirect taxation investment incentives.

- Securities issued by public bodies and arising from the construction or operation of infrastructure or facilities in the public interest for the public authorities in the Canary Islands, where the funding obtained from the issue is allocated exclusively to such construction or operation, subject to a limit of fifty percent of the provisions recorded in each year.
- The option of making advance investments against the provision relating to the actual year in which the investment is made and the following three years, out of income obtained through December 31, 2020, is maintained.

1.3 Property leasing, treatment as a business activity

- (a) The royal decree-law provides that property leasing will be treated as a business activity only where the circumstances set out in article 27.2 of Personal Income Tax Law 35/2006 are present.
- (b) For these purposes, it must be taken into account that this article has been amended as a result of the approval of Law 26/2014, of November 27, 2014, and therefore, effective January 1, 2015, property leasing will be treated as an economic activity where, in organizing it, at least one full-time employee is used. The previous requirement regarding premises used exclusively for the activity has been eliminated.
- (c) It must be remembered that the above requirement is of crucial importance when it comes to determining both whether the income may be allocated to the provision to the RIC, and whether a reinvestment in properties intended for leasing may be considered as eligible for the purposes of the RIC.

1.4 Investment plans. Elimination of the obligation

The obligation to submit an investment plan as a requirement for use of the reserve has disappeared (which will do away with the costs involved in preparing and submitting it), as well as the rules on penalties for a breach of this requirement.

1.5 Transitional provisions

1. Provisions to the reserve for investments originating from income in tax periods that commenced before January 1, 2015 will be governed by the provisions set out in article 27 of Law 19/1994, as worded until December 31, 2014.
2. Advance investments made in a tax period that commenced before January 1, 2015 will be treated as a use of the reserve for investments of income obtained in another subsequent tax period that also commenced before that date, and will be governed by the provisions set out in article 27 of Law 19/1994, as worded until December 31, 2014.
3. Any income on which the tax credit set out in article 42 of the Revised Corporate Income Tax Law, approved by Legislative Royal Decree 4/2004, of March 5, 2004, has been taken cannot be allocated to the RIC.

2. New tax credits: Tax credit for investments in West Africa and for advertising and publicity expenses

Two new tax credits are created with the goal of increasing investments in the Canary Islands aimed at facilitating and promoting the use of the archipelago as a platform for making investments in West Africa and fostering the internationalization of the Canary Islands economy.

Accordingly:

- Entities subject to corporate income tax with their tax domicile in the Canary Islands whose net revenues in the immediately preceding tax period are equal to or less than €10 million and with an average headcount in that period below 50 employees, will be entitled to take the following tax credits against their gross tax payable:

1. A total of 15 percent of investments actually made to set up subsidiaries or permanent establishments in Morocco, Mauritania, Senegal, Gambia, Guinea-Bissau and Cape Verde, provided that these entities carry on economic activities within 1 year after the investment is made. Where subsidiaries are set up, the holding in the subsidiary must be owned by entities that have their tax domicile in the Canary Islands.

To be able to take the tax credit, the entity alone or together with other entities that have their tax domicile in the Canary Islands must have a percentage holding in the capital or equity of the subsidiary amounting, at least, to 50 percent.

The tax credit must be taken in the tax period in which the investee or the permanent establishment commences economic activities, and will be conditional on increasing the taxpayer's average headcount in the Canary Islands in that tax period compared with the average headcount existing in the preceding tax period, as well as on maintaining the increase for 3 years.

2. A total of 15 percent of the amount paid in respect of multiyear advertising and publicity expenses for launching products, opening up and exploring markets abroad and attending fairs, exhibitions and similar events including, in this case, those held in Spain as international events.
- These tax credits will be 10 percent where the net revenues figure is above €10 million but below €50 million, and the above-mentioned average headcount is equal to or greater than 50 employees but below 250.
 - In the case of entities that form part of a group of companies within the meaning of article 42 of the Commercial Code, regardless of their residence and the obligation to prepare consolidated financial statements, the net revenues figure and the average headcount will refer to all the entities belonging to the same group.
 - For newly created entities, the net revenues figure will refer to the first tax period in which the entity actually carries on the activities. If the immediately preceding tax period was shorter than a year, or the entity carried on activities for under a year, the net revenues figure will be grossed up to one year.

3. Canary Islands Special Zone

The legislation on the Special Canary Islands Zone (the “ZEC”) has been changed very considerably with the aim to drive its primary objectives of economic and social development and diversification of the Canary Islands economy.

Accordingly, the restrictions which have hitherto prevented a full implementation of this incentive have been corrected by way of the following measures:

1. Generalization of its territorial scope to the entire archipelago, hitherto only permitted for service activities, which puts an end to the existing restriction confining activities related to the production, processing, handling or marketing of goods to certain geographical areas.
2. Broadening the potential beneficiaries, by making it applicable to branches: it is still necessary for companies, and now branches, to be newly created.
3. Significant rise in the limits on the taxable income linked to the creation of jobs, to apply the special corporate income tax rate of 4%.

The amount of taxable income eligible for the 4% rate will now be determined according to the following rules:

- €1,800,000 for ZEC entities meeting the minimum job creation requirement.
- An additional €500,000 for every job over and above the minimum, up to 50 jobs.
- The creation of more than 50 jobs, as well as the job creation requirements referred to in the two preceding rules, will be subject in all cases to the following limit: the reduction of the gross tax payable in each tax period, after applying the special rate in the ZEC, in relation to the standard corporate income tax rate, may not exceed 17.5% of the net revenues of the ZEC entity, where the entity belongs to the industrial sector, or 10% of that figure, where the entity belongs to another sector.

For these purposes, “net job creation” means the net number of jobs created in the geographical area of the ZEC since the entity was authorized, excluding any employees who have been in the workforce previously.

Any variations in the net job creation will take effect in the tax period in which they occur.

4. Elimination of the restriction on taking the domestic double taxation tax credit for dividends relating to holdings in ZEC entities and arising from income that has been subject to the 4% corporate income tax rate, as well as on gains obtained on the transfer of ZEC entities. The general rules and requirements will apply to the exemption for dividends and gains obtained on the transfer of shares in companies regulated in the new Corporate Income Tax Law in force since January 1, 2015.
5. Expansion of the list of activities that qualify for the regime: this list is attached as an exhibit to this Commentary.
6. Lastly, the length of the regime is extended, by maintaining the timeframe used until now, with a period for registering on the Official ZEC Entity Register which will end in 2020, and adding a second period in which the beneficiaries registered on this register can enjoy the regime, which will run until 2026.

4. Other new legislation

4.1 *Tax credit for technological innovation activities that are carried on in the Canary Islands*

The rate for the tax credit for technological innovation activities that are carried on in the Canary Islands and meet the criteria laid down in article 35.2 of Corporate Income Tax Law 27/2014, of November 27, 2014, will be 45 percent and will not be subject to the provisions of article 94.1.a) of Law 20/1991, of June 7, 1991, amending the tax aspects of the Canary Islands Economic and Tax Regime

4.2 *Limits on tax credits for investments in motion picture productions, audiovisual series and live theater and musical performances taking place in the Canary Islands*

The amount of the tax credit for investments in Spanish feature films and audiovisual series consisting of fiction, animation or documentaries, as referred to in article 36.1 of the Corporate Income Tax Law, may not exceed €5.4 million where the production takes place in the Canary Islands.

The amount of the tax credit for expenses incurred in Spain in respect of foreign productions of feature films or audiovisual works, as referred to in article 36.2 of the above-mentioned law, may not exceed €4.5 million where the expenses are incurred in the Canary Islands.

The amount of the tax credit for expenses incurred in producing and putting on live theater and musical performances, as referred to in article 36.3 of the same law, may not exceed €900,000 where the expenses are incurred in the Canary Islands.

5. Application of EU legislation

For the first time the legislation on the Canary Islands Economic and Tax Regime includes certain provisions expressly aimed at ensuring that the application of its tax incentives complies with EU legislation, and at regulating the consequences of a breach.

5.1 *Tax relief disallowed where it involves unlawful and incompatible state aid*

Parties who have received state aid that has been declared unlawful and incompatible with the common market may not apply the tax relief regulated in Law 19/1994, of July 6, 1994, amending the REF, or in Law 20/1991, of June 7, 1991, amending the tax aspects of the REF, and constituting state aid according to EU law, until the unlawful and incompatible aid has been fully repaid.

5.2 *Compliance of incentives available under the Canary Islands Economic and Tax regime with EU law*

The rules on and application of incentives available under the REF must comply with EU legislation.

In particular, the provisions of Commission Regulation (EU) No. 651/2014 of 17 June 2014, declaring certain categories of aid compatible with the internal market in application of articles 107 and 108 of the Treaty, must be observed.

The application of tax relief that is treated as regional operating aid as set out in Book II and in article 94 of Law 20/1991, in Law 4/2014, of June 26, 2014, amending the rules on the levy on imports and supplies of goods in the Canary Islands, in articles 26 and 27 and in Title V of Law 19/1994, and in additional provision twelve of Corporate Income Tax Law 43/1995, of December 27, 1995, as well as aid to the transportation of goods included within the scope of Royal Decree 362/2009, of March 20, 2009, on compensation for the sea and air transport of goods not included in annex I to the Treaty establishing the European Community, with origin or destination in the Canary Islands, and in the Order of July 31, 2009 of the Department of Public Works and Transportation of the Canary Islands government, approving the basis of the indefinite term for granting subsidies to the inter-island transport of goods not included in annex I to the Treaty establishing the European Community, will be subject to the overall limit of 17.5 percent of the annual turnover obtained by the beneficiary in the Canary Islands, where the entity belongs to the industrial sector, or 10 percent of that turnover, where the entity belongs to any other sector included within the scope of application of the above-mentioned Regulation No. 651/2014.

For these purposes, all of the activities included in divisions 1 to 4 of section one of the rates for the tax on economic activities, approved by Legislative Royal Decree 1175/1990, of September 28, 1990, approving the rates and the instruction for the tax on economic activities will be deemed to be included in the industrial sector.

The state aid for the tobacco industry, within the context of the REF, will apply on the same terms as those applicable to the rest of the industrial sector, unless the application of a higher threshold is permitted pursuant to the mandatory EU authorization.

5.3 Monitoring of state aid

The accumulation of the aid obtained as a result of all the incentives available under the REF, as well as any others, whatever their nature, that are treated as state aid, will be subject to a monitoring and control system.

To this end, a new obligation is laid down whereby beneficiaries must file a special informative return for the various aid measures and regimes used. This return will include detailed information on these incentives, which will be subject to verification.

Exceeding the aid accumulation limits will constitute an infringement, the penalty for which will be a proportional fine equal to 20 percent of the excess.

The repayment of the excess aid and the imposition of the penalty will be carried out according to the relevant procedures depending on the nature of the aid.

The development and application of the monitoring and control system will be implemented by regulations.

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Exhibit**ZEC****List of authorized economic activities
(according to NACE Rev. 2 classification)**

- 01.28 Growing of drugs and pharmaceutical crops
- 03 Fishing and aquaculture
- 10 Manufacture of food products
- 11 Manufacture of beverages
- 12 Manufacture of tobacco products
- 13 Manufacture of textiles
- 14 Manufacture of wearing apparel
- 15 Manufacture of leather and related products
- 16 Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials
- 17 Manufacture of paper
- 18 Printing and reproduction of recorded media
- 20 Manufacture of chemicals, except 20.6 Manufacture of man-made fibers
- 21 Manufacture of pharmaceutical products
- 22 Manufacture of rubber and plastics products
- 23 Manufacture of other non-metallic mineral products
- 25 Manufacture of metal products, except machinery and equipment, except 25.4 Manufacture of weapons and ammunition
- 26 Manufacture of computer, electronic and optical products
- 27 Manufacture of electrical equipment
- 28 Manufacture of machinery and equipment n.e.c.
- 30.12 Building of pleasure and sporting boats
- 30.3 Manufacture of remote control aircraft
- 30.92 Manufacture of bicycles and invalid carriages
- 31 Manufacture of furniture
- 32 Manufacturing n.e.c.
- 33 Repair and installation of machinery and equipment
- 35.1 Generation, transmission, distribution and marketing of electricity from renewable energy sources
- 36 Water desalination using renewable energy sources
- 37 Waste water collection and treatment
- 38 Waste collection, treatment and elimination; recovery

- 39 Remediation activities and other waste management services
- 41.20 Refurbishment, restoration, remodeling or renovation of buildings or spaces. On-site assembly of prefabricated structures
- 45 Sale and repair of motor vehicles and motorcycles, except retail trade of motor vehicles and motorcycles and associated parts and accessories classified in 45.1, 45.32 and 45.4
- 46 Wholesale trade, except of motor vehicles and motorcycles
- 49 Land transport and transport via pipelines
- 50 Water transport
- 51 Air transport
- 52 Warehousing and support activities for transportation
- 53 Postal and courier activities
- 58 Publishing activities
- 59 Motion picture, video and television program production, sound recording and music publishing activities, except 59.14 Motion picture projection activities
- 61 Telecommunications
- 62 Programming, consultancy and other information technology activities
- 69 Legal and accounting activities
- 70 Activities of head offices; management consultancy activities
- 71 Architecture and engineering activities; technical testing and analysis
- 72 Research and development
- 73 Advertising and market research
- 74 Other professional, scientific and technical activities
- 77.4 Leasing of intellectual property and similar products, except copyright-protected work
- 78 Employment activities
- 79 Travel agency, tour operator and other reservation service activities
- 80 Security and investigation activities
- 82 Office administrative, office support and other business support activities
- 85.32 Technical and vocational secondary education
- 85.4 Post-secondary education
- 85.5 Other education
- 85.6 Educational support services
- 86.9 Other health activities
- 87.1 Residential nursing care facilities
- 93.19 High performance sports facilities
- 93.21 Activities of amusement and theme parks
- 96.04 Physical well-being activities

Where the name of the activity does not entirely match that of the NACE code in question, the former prevails.

Each of the activities 10, 11, 12, 13, 14, 15, 16, 17, 18, 20, 21, 22, 23, 25, 26, 27, 28, 30.12, 30.3, 30.92, 31 and 32, include the activities of rental or any other activity engaged in by manufacturers to place their products on the market.

Coordination and intragroup service centers are excluded from the activities included in categories 70.10 "Activities of head offices" or 70.22 "Business and other management consultancy activities".