GARRIGUES

bulletin TAX

5-2013
May, 2013

IMPAIRMENT LOSSES ON SHARES

The calculation of the provision for tax-deductible impairments, in the case of group entities, jointly controlled entities and associates has become more complex since the entry into force of the new Spanish National Chart of Accounts and the subsequent amendment of the Spanish Corporate Income Tax Law, because tax law ignores accounting recognition rules completely.

In addition to the necessary reconciliation of the investee's financial statements to Spanish GAAP, to determine the value of the decline in its equity for these purposes, the investee's nondeductible expenses must be ascertained and whether there were any unrealized gains on acquisition that remain when the impairment is calculated.

The treatment for tax purposes of this item can mean a departure from the timing of recognition rules contained in the law which, generally speaking, allow deduction in the year in which a given expense is recorded for accounting purposes even if it is recorded in a later fiscal year than the year in which it was actually incurred. This special rule can lead to the interpretation (such as the one made by the Directorate-General of Taxes) that no adjustment can be made in this connection in a year other than the one to which it technically relates.

In a recent ruling, the Directorate-General of Taxes stated that this “clear separation between years” when it comes to the impairment of shares can also be extended to the time of the transfer of the shares and that it also affects any losses that may be incurred on that transfer.

Specifically, the view of the Directorate-General of Taxes is that:

- We are dealing with an impairment purely for tax purposes. Therefore, any provision for accounting purposes will be nondeductible and the impairment for tax purposes must be reflected by way of an adjustment to book income in the relevant corporate income tax return.

- Because they are adjustments to book income, an impairment cannot be deducted in a year other than the year in which it was incurred, so, if in a given year the relevant impairment for tax purposes has not been deducted, the only way to do so will be to apply to correct the tax return for that year. If the correction has not been made, in the event the shares are sold, the portion of the loss equal to the impairment for tax purposes not deducted at the time will not be deductible.

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- As an exception, the impairment for tax purposes from another preceding year can be used where in that year equity was negative and there was not enough cost to use the whole of the deductible loss.

The stream of ruling requests appearing on this subject shows that the impairment of shares is currently widespread among corporate groups and also that it is subject to complex accounting and tax rules. In light of the administrative rulings in this respect, it is advisable to carry out a thorough analysis of its effects.

1. JUDGMENTS

1.1 Corporate income tax.- An "exit tax" is contrary to the freedom of establishment where a company transfers its residence to another member state (Court of Justice of the European Union. Judgment of April 25, 2013 in case C-64/11)

This judgment analyzed whether it is contrary to EU law to tax the unrealized gains on the assets of a company or of a permanent establishment that transfers its residence to another EU member state. The court held that it *is* contrary if the transaction is not taxed if it takes place within the member state itself.

The judgment thus reiterates the case law already established in other cases concerning so-called "exit taxes" in the European Union, concluding that (i) although the "assessment" of the tax relating to the gains generated during the time in which the economic activity was carried on in the member state is justified by the need to preserve the tax sovereignty of that state, (ii) it is not proportionate to demand the immediate payment of the tax, as other measures may be established which are less restrictive of the freedom of establishment (collection of the tax at the time the gain would have been taxed had the transfer not taken place).

1.2 Collection procedure.- Late-payment interest relating to the refund of a tax contrary to EU law (Court of Justice of the European Union. Judgment of April 18, 2013 in case C-565/11)

The court analyzed whether a national law that limits interest when a tax received in breach of EU law is refunded is lawful. In this case, the interest was limited to the interest accrued from the day following the date of the claim for a refund of the tax.

Although in this specific case the law at issue applied this calculation rule both to the taxes collected in breach of EU law and to those collected in breach of national law, the court concluded that, based on the principle of effectiveness, the calculation of interest cannot lead to depriving the taxpayer of adequate compensation for the loss sustained through the undue payment of the tax, and that the law in question did not meet that requirement.

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1.3 Corporate income tax.- Depreciation of a building for which the lease agreement does not provide for renewals can be taken by reference to the term of the agreement (Madrid High Court. Judgment of April 17, 2013)

The company had been depreciating the assets built on a leased building over the useful life of the assets. It later decided to take accelerated depreciation because it had noticed that the lease agreement did not provide for an express renewal at the end of its term and, therefore, the useful life of the assets coincided with the term of the agreement. In the year in which it made this decision, it also made an adjustment to recognize the amount not deducted in prior years.

The tax inspectors considered that this decision entailed an unjustified change in the depreciation method and was therefore invalid on the grounds that in the year in which the decision to change the depreciation rate was made there were no new circumstances different from those present when the lease agreement was signed that justified this new decision.

After examining the clauses of the lease agreement, the court determined that the agreement was for a definite term in that it established that for it to continue at the end of the term the parties had to negotiate anew; in other words, no implicit renewal upon termination of the lease period had been stipulated. Therefore, the truth is that the company could, from the outset, have chosen to depreciate the assets over the term of the agreement and, if it did not, nothing prevents it from doing so later when it noticed the mistake. Accordingly, the court validated both the application of the new depreciation rates in the future (accepting that there was no change in the depreciation method because the depreciation continued to be straight-line but over a shorter period) as well as the adjustment for depreciation not taken in prior years.

1.4 Corporate income tax.- Sum-of-the-digits depreciation is compatible with a reduction in useful life due to a dual shift if it reflects an actual decline in value (National Appellate Court. Judgment of February 7, 2013)

The tax authorities refused to allow the taxpayer to apply the sum-of-the-digits declining balance depreciation method to a cogeneration plant that simultaneously applied the depreciation by shifts method, because they considered that systems for depreciating assets used during “several work shifts” and the sum-of-the-digits method are incompatible (in that they are both accelerated depreciation systems).

The National Appellate Court held that the article in the regulations that determined this incompatibility could not be used to ignore the actual situation of the assets and that it had to be interpreted in accordance with legal principles, one of which is that of the “actual decline in value” of the assets.

In this respect, not allowing the joint application of the two methods would lead to an absurd situation in which two identical assets, both depreciated under the declining balance method, would give rise to the same depreciation charges in each fiscal year, even though one of them, the dual shift one, would be used more intensively than the other.

Thus, in light of the expert evidence taken in the proceeding which showed that the cogeneration plant would have a useful life of 15 years and with the dual shift, 7.5 years, and considering that the system followed by the taxpayer reflects the actual decline in value, the court ruled that the two depreciation methods were compatible.

1.5 Personal income tax.- Having an "employee and premises" is not an essential condition to consider that leasing real estate constitutes an economic activity, although it is an important piece of evidence (National Appellate Court. Judgment of February 28, 2013)

In this case the court analyzed, with respect to the tax credit for the reinvestment of extraordinary income, whether or not the property in which the reinvestment was made, which was leased out, was used in an economic activity.

The National Appellate Court analyzed the fulfillment of the "employee and premises" requirements established in the Personal Income Tax Law for considering that the leasing of real estate may be treated an economic activity.

For these purposes, and following the line of reasoning contained in the latest rulings by the Central Economic-Administrative Tribunal (TEAC), the court considered that the existence of independent premises and of a person under a full-time employment contract for the performance of the leasing business is not an essential requirement to consider that it constitutes an economic activity, in that this circumstance could be evidenced by any other valid means of proof.

In short, the two requirements are not an essential condition to consider that the leasing of real estate is done as an economic activity, but rather they are only important evidence to presume that that activity is carried on (or not).

1.6 Personal income tax.- The special tax-exempt status of per diems for personal income tax purposes only applies to income obtained from an employment relationship (High Court of the Principality of Asturias. Judgment of January 30, 2013)

The appellant had a charter-based relationship with the Health Service of Asturias (SESPA) and did not include in his taxable income certain amounts received to defray travel and accommodation expenses, on the understanding that they were exempt from personal income tax.

The court considered that the charter-based relationship fell within the scope of public services and could not be considered a special "employment" relationship but rather a charter-based relationship, which prevented the application in this case of the special tax-exempt status of per diems for personal income tax purposes.

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1.7 Enforcement of secondary liability.- The sole shareholder and director cannot challenge the facts of the case again in enforcement of secondary liability for company's tax debts (National Appellate Company. Judgment of February 18, 2013)

In this case, the sole shareholder and director of the principal debtor company which had been adjudged bankrupt were held to be jointly and severally liable with the company. The sole shareholder and director challenged the assessments that gave rise to the enforcement of secondary liability, asserting, against the facts of the case, arguments that had already been asserted by the company.

The court held that although case law allowed the secondary debtor to assert any arguments within its reach, including the challenge of assessments, in this particular case, the court was not allowed to entertain them and rule on them, because it involved a sole-shareholder company, with a sole shareholder and director, who is attempting to use two appeals to challenge the same facts.

The court considered that although it is true that the claims were submitted to the High Court on behalf of the company, and that they are now being defended in the appellant's own behalf, it must be held that the effects of the initial judgment apply not only to the company but also to the sole shareholder who is now appealing. In the view of the court, revisiting the facts of the case in relation to the assessments would entail, in this specific case, infringing the principle of *res juditica* and legal certainty.

1.8 Inspection proceeding.- The classification of a transaction by the tax inspectors with respect to a taxpayer is binding on the inspectors for other taxpayers in an identical case (National Appellate Court. Judgment of February 14, 2013)

At issue in this case was whether the plaintiff qualified for deferral in respect of the reinvestment of extraordinary income on the transfer of a percentage of a plot of land that was used to rent billboards. The inspectors considered that the rental activity fell outside the scope of the entity's corporate purpose and was therefore a marginal activity. Consequently, the inspectors considered that the plot could not be treated as property, plant and equipment used in economic operations.

The National Appellate Court reviewed its case law on this subject and accepted the inspectors' arguments that the transferred plot should have been classified as inventory. The court said, however, that it was compelled to uphold the company's appeal because the inspectors themselves had acknowledged that the plot was property, plant and equipment in relation to another co-owner of the plot and had allowed deferral in that case.

The court was of the view that the inspectors cannot change the criteria they applied to another entity and deny the application of the deferral to the plaintiff, whose tax and accounting position were identical to that of the co-owner in relation to the asset. The correct approach would have been for the inspectors to have carried out a review of the tax adjustment applied to the co-owner in order to issue a new assessment disallowing the deferral, which it did not do.

2. DECISIONS AND RULINGS

2.1 Corporate income tax. Verification of tax credits generated in a statute-barred fiscal year but taken in year open for review in which General Taxation Law 58/2003 is in force (Central Economic-Administrative Tribunal. Decision of March 21, 2013)

The Central Economic-Administrative Tribunal (TEAC) reaffirmed its view on the tax inspectors' ability to inspect the source and amount of a tax credit reported in a statute-barred year but which is to be taken in a year open for review.

Specifically, the TEAC cited its decisions of February 26, 2009 and January 31, 2013, in which it held that certain Supreme Court and National Appellate Court judgments cannot serve as interpretative precedents because they referred, in any case, to cases in which the offset or deduction took place in a fiscal year in which General Taxation Law 58/2003 was not in force.

In the case analyzed, the taxpayer also stated that the tax credits had been generated in a statute-barred year that had already been inspected previously and therefore should be deemed as accepted. However, the TEAC, on the basis of two decisions of February 28, 2013 and September 27, 2012, held that from the content of the documents signed in the previous inspection, it did not transpire that there was an express verification of the tax credits, for which reason it stood by its conclusion.

2.2 Corporate income tax – Deductibility of finance costs in intragroup transactions (Directorate-General of Taxes. Ruling V0398-13, of February 11, 2013; Rulings V0878-13, V0880-13 and V0882-13, of March 19, 2013)

According to article 14.1.h) of the Revised Corporate Income Tax Law (TRLIS), the finance costs incurred in the tax period, derived from debts with group entities and used to acquire, from other group entities, investments in the capital or equity of any type of entity, or to make contributions to the capital or equity of other group entities, will not be treated as tax deductible expenses unless the taxpayer proves that there are valid economic reasons for carrying out those transactions.

The Directorate-General of Taxes (DGT) analyzed in various rulings the economic reasons provided to support the deduction of this type of expenses. It noted, in this regard, that in general it is necessary for the transactions to be reasonable from an economic standpoint, such as for example, a restructuring within the group, a direct consequence of an acquisition from third parties, or cases where there is genuine management of the investees from Spain.

On the basis of these general parameters, the DGT considers that the following economic reasons, among others, would allow the finance costs derived from intragroup loans to be deducted:

- Centralization at a Spanish holding entity of the corporate services and functions that certain employees provide to the benefit of the group worldwide, such that the various businesses carried on in Spain are rationalized, and centralized and subordinated at that holding entity.

- Adaptation of the corporate structure to the investees' operating and management structure; simplification of the structure of the governing bodies of the investees; strategic improvement of the business focus or to allow the entry of shareholders.

- Restructuring of the group's financial situation to reduce debt ratios, obtain new resources and strengthen financial position; to group entities together in order to make them more attractive to foreign investors; or to improve the financial and operational management of the group companies.

2.3 Corporate income tax – Effects of subrogation, for no consideration, to the debtor position of another company (Directorate-General of Taxes. Ruling V0854-13, of March 19, 2013)

In the case analyzed, the parent entity of a tax group had debts in respect of a loan. It was decided that a subsidiary would be subrogated, for no consideration, to the parent entity's position as borrower. The ruling analyzed the corporate income tax effects of this assignment for no charge.

The issue was conveyed to the Spanish Audit and Accounting Institute for it to determine the accounting treatment of the transaction, and it noted that the subrogation of debt for no consideration is essentially similar to a remission of debt, given that both transactions present the characteristics of gifts. Consequently, repeating the views taken in previous rulings, the DGT ruled that:

- The subsidiary must recognize the debt to which it is subrogated through a charge to a reserves account.

- The parent company will cancel the debt with a credit to an account representing the economic basis of the transaction, which could be the distribution of income or the recovery of the investment which has determined the changes in the subsidiary's equity since the acquisition date.

From a tax standpoint, and bearing in mind that the two companies form a tax group, the DGT established the following criteria:

- The portion of the income recognized by the parent that relates to the percentage ownership of the subsidiary will be eliminated pursuant to article 72 of the TRLIS.

- The portion of income not related to the percentage ownership will give rise to an extraordinary book expense at the donor company (the subsidiary) which will not be tax deductible because it entails a gratuity.

  A matching revenue will arise at the recipient company, which will not be eliminated, as otherwise, the revenue and matching expense would have had to be included in the individual tax bases, which is not the case of the expense because it is not tax deductible.

2.4 Corporate income tax – The impairment of investments in group entities, jointly controlled entities and associates, is only deductible in the fiscal year in which the underlying book value decreases (Directorate-General of Taxes. Ruling V0757-13, of March 12, 2013 and ruling V0873-13, of March 19, 2013)

As we have mentioned in previous bulletins, article 12.3 of the TRLIS contains a specific tax regime for determining the deductibility of the impairment of investments in group entities, jointly controlled entities and associates, irrespective of the accounting treatment applied.

The DGT's view is that the adjustments deriving from this tax regime cannot be made to the tax base in a later fiscal year than the year in which they should have been made, unless the shareholder's investment is fully impaired (tax cost equal to zero) and the investee has negative equity.

Ruling V0757-13 rectifies and replaces another earlier one (V2101-12), stating as follows:

- That article 19 of the TRLIS on timing of recognition rules, which allows an expense recognized after it was incurred to be deducted in the fiscal year in which it is recognized in the accounts (where this does not give rise to lower taxation), refers to the revenue and expense items determining the tax base, that is, the revenues and expenses for accounting purposes.
- That the deductible items of article 12.3 of the TRLIS (for group entities, jointly controlled entities and associates) are for tax purposes and therefore the timing of recognition rules in article 19 do not apply to them. Accordingly, the deduction can only be made in the tax period in which impairment of the investee has occurred for tax purposes pursuant to the rules of article 12.3 of the TRLIS.
- That if, in any specific fiscal year, the taxpayer has not deducted the appropriate amount pursuant to article 12.3 of the TRLIS, the only way it can deduct it is by correcting the self-assessment for that year (pursuant to article 120 of the General Taxation Law).
- That, nonetheless, if the investment is fully impaired and the investee has negative equity, because the impairment of the investee in that year cannot be deducted, the portion that has not been deducted may be deducted in a later fiscal year in which the value of the investment may have increased because a contribution has been made to the equity of the investee.

  Finding otherwise, according to the DGT, would mean disregarding for tax purposes the actual existence of the impairment of the investment and discriminating against the deduction according to the fiscal year in which the contribution to the investee's capital was made.

- The DGT concludes by stating that this reasoning applies even in the case of transfer of the investment. In that case, the income to be included in the tax base of the transferor must take into account the tax adjustments that the transferor should have made in the fiscal years in which it held the investment, even if it did not make those adjustments.

These rules, designed to avoid a tax advantage being obtained from an incorrect timing of recognition, may mean that a loss actually incurred by the transferor and recognized in full for accounting purposes can never be deducted.

Ruling V0757 also emphasizes that in the tax return, the taxpayer must make a positive adjustment to the tax base in respect of the impairment for accounting purposes and a negative adjustment for the impairment for tax purposes, even if they are both the same amount.

Moreover, ruling V0873-13 analyzes a case where the financial statements of the investee were reprepared in a later fiscal year than the year in which they were originally prepared and approved. In these cases, the DGT held that every fiscal year, the impairment for tax purposes must be calculated by reference to the prepared and approved financial statements that are available at the time; and that if they are subsequently reprepared, it will be in that fiscal year when the effect of the repreparation of the financial statements must be reflected.

2.5 Corporate income tax. Asset revaluation may be applied to construction in progress (Directorate-General of Taxes. Ruling V0724-13, of March 11, 2013)

The new asset revaluation applies to elements of property, plant and equipment and real estate investments. The issue raised was whether construction in progress falls within these categories.

In this connection, the DGT stated that "property, plant and equipment" is an accounting concept that must be interpreted under accounting legislation. Accordingly, given that construction in progress forms part of property, plant and equipment, it can be revalued.

In these cases, the revaluation multipliers must be applied to the acquisition price of the assets (determined under accounting legislation) by reference to the year in which the construction in progress was recognized for accounting purposes, because that is when the asset is included in the balance sheet and, thus, deemed to be economically controlled by the company.

2.6 Personal income tax.- Simulation exists in the interposition of a company between a professional services firm and the professional partners working at that firm (Central Economic-Administrative Tribunal. Decision of March 21, 2013)

The TEAC analyzed a case in which:

- A firm provided professional services to its clients, and billed them for those services.

- Clients were advised by the professional partners at that firm. Those partners billed the firm in two ways: directly and through companies owned by them.

The TEAC concluded that the case involved simulation because the companies interposed by the partners had no purpose other than to enable a reduction in the partners' withholdings and, in turn, their taxation.

2.7 Personal income tax.– Indemnification of the withholding agent by the party subject to withholdings where withholding deficiency is assessed (Directorate-General of Taxes. Ruling V0827-13, of March 14, 2013)

The DGT was asked whether a company could claim from a worker the withholdings not made from payments made to him where the tax authorities were claiming the withholdings from the company.

The DGT repeated in this ruling that the breach of the obligations established for withholding agents does not allow in a strictly tax context any amount to be deducted from the worker's income or any amounts owed to be claimed in respect of the withholdings not originally made, although, the DGT adds, there are other possible procedures for the party subject to withholdings to indemnify the withholding agent.

Although this ruling does not specify what those procedures are, it may be understood that the most appropriate would be in the civil jurisdiction, given that the withholding agent would be paying an amount on account of a debt of a third party, the worker.

3. LEGISLATION

3.1 Corporate income tax and nonresident income tax returns

In the Official State Gazette of May 20, 2012 Order HAP/864/2013, of May 14, 2012 was published, approving the corporate income tax and nonresident income tax forms for permanent establishments and entities subject to tax transparency rules created abroad with a presence in Spain, for the tax periods commenced between January 1 and December 31 2012.

Although no significant changes have been made to the format of the form, it has been adapted to the numerous amendments made in 2012 (such as, for example, the restriction on the deduction of finance costs, the time limit for offsetting tax losses or the asset revaluation).

It should be remembered that, before filing the return, it might be necessary to provide certain additional information on specific forms. This must be done where:

- the book income has gone down by 50,000 euros or more in the section relating to "other adjustments to the income/loss in the income statement" (box 414 of page 13 of the tax return);

- the amount of tax credits for reinvestment of extraordinary income, for environmental investments or for research and development and technological innovation activities generated in the fiscal year is 50,000 euros or more (regardless of whether the tax credits are taken or are left for future fiscal years).

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Additionally, if the taxpayer elects to apply the asset revaluation rules contained in Law 16/2012, it must have completed the self-assessment of the single tax on that revaluation before filing the tax return.

The main change to filing instructions is that companies that have elected to apply the asset revaluation rules must file their corporate income tax return or nonresident income tax return for permanent establishments remotely in all cases.

Readers are reminded that filing remotely online will be compulsory in general where the filer is registered with the Large Taxpayers Central Office or the Large Enterprises Management Units of the State Tax Agency, and in the case of taxpayers that have the legal form of a corporation (*sociedad anónima*) or limited liability company (*sociedad de responsabilidad limitada*), or of entities that have to provide the additional information mentioned above.

For all other taxpayers, the only alternative to filing remotely online, would be to file a print-out of one of the approved forms, completed on the State Tax Agency's webpage.

No changes have been made to the return filing period, so for entities whose tax period is the same as the calendar year, the filing period will be the first 25 days of July 2013 (in the case of payment by direct debit, up to July 20, 2013). For all other entities, the filing period will be the 25 calendar days following the six months after the end of the tax period. However, taxpayers whose tax return period commenced before the entry into force of this Order must file a return within the 25 calendar days following that entry into force, unless they have elected to file it using the forms approved for the fiscal years commenced in 2011, in which case the filing period will be the standard period.

This Order will take effect on July 1, 2013.

3.2 Forms 108 and 208 (asset revaluation) and forms 202 and 222 for making corporate income tax prepayments

Order HAP/636/2013, of April 15, 2013, published in the Official State Gazette of April 19, 2013, approves the forms for taxpayers that elect to apply the asset revaluation approved in Law 16/2012.

Personal income taxpayers must use form 108 in the period between and including April 24 and July 1, 2013 (in the case of payment by direct debit, up to and including June 26, 2013).

Corporate income taxpayers and nonresident income taxpayers operating in Spain through a permanent establishment must use form 208, for which the filing period coincides with that of the tax return for those taxes (for the tax period relating to the balance sheet in which the revaluation transactions were registered). Direct debit may be used by taxpayers whose tax period ends on December 31, 2012, from July 1 until July 20, 2013, both inclusive.

In both cases, the returns must be filed remotely and along with the personal income tax return for 2012 or with the corporate income tax or nonresident income tax return for the period to which the revaluation relates.

The late filing of these forms will be a ground for invalidating the asset revaluation transactions.

The aforementioned Order also modifies the forms for corporate income tax prepayments (forms 202 and 222) to allow for different treatment to the prepayments of entities subject to the regime for shipping entities according to tonnage.

3.3 Form 583 for the tax on the value of electricity production

Order HAP/703/2013, of April 29, 2013, published in the Official State Gazette of April 30, 2013, approved form 583 for "Tax on the value of electricity production. Self-assessment and prepayments" created by Law 15/2012, of December 27, 2012, on tax measures for energy sustainability.

The form will be valid for both self-assessing and paying the tax and for making prepayments.

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