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FINANCE COSTS: RULING BY THE DIRECTORATE-GENERAL OF TAXES OF JULY 16, 2012

Royal Decree-law 12/2012, of March 30, 2012 subsequently amended by Royal Decree-law 20/2012, of July 13, 2012, introduced to corporate income tax legislation a general limit on the ability to deduct finance costs (i.e. borrowing costs) which replaced the former thin capitalization rule[1].

Put briefly, effective for periods that begin on or after 1 January 1, 2012, the taxpayers affected by that limit can only deduct their net finance costs for the period up to a limit of 30% of their operating income (with a minimum deduction of 1 million euros), although (i) any excess amounts that have not been deducted can be used in the 18 subsequent periods and, also, (ii) if the net costs are under that limit, the difference can be added to the limit in the following five periods.

Following the many doubts arising in connection with the legislation, the Directorate-General of Taxes has issued a Ruling, dated July 16, 2012, published in the Official State Gazette (the "BOE" after its initials in Spanish) of July 17, 2012, setting out the interpretation rules to be applied, which we summarize below. The Ruling contains an array of very useful numerical examples, to which we refer to for a better understanding of the matter and which will have to be used if further doubts arise, since we are faced with general rules that will have to be applied to scenarios with a broad range of features.

1. DEFINITION OF FINANCE COST AND INCOME

The new article 20 of the revised Corporate Income Tax Law provides that:

Net finance costs will be deductible to the extent of 30 percent of operating income for the period.

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[1] This limit on the amount of net finance costs allowed to be deducted is separate from the prohibition, also appearing in Royal Decree-law 12/2012, on deducting the finance costs in connection with intra-group debt acquired to purchase shares from other group companies, or to make contributions at other group companies, unless valid economic grounds for these transactions can be evidenced (article 14.1.h) of the revised Corporate Income Tax Law).

For these purposes "net finance costs" shall mean the amount by which finance costs exceed the income earned in the tax period on own funds lent to third parties, not including those costs referred to in article 14.1.h) of article 14 of this Law.

In relation to the definition of net finance cost, the Ruling of the Directorate-General of Taxes sets out the following:

- A description of the accounting items that must be used to determine these costs.

  Based on the idea that net finance costs are the difference between finance costs and finance income, and that this difference only makes sense if those items are uniform, it states that:

  - Finance costs mean the costs derived from debts with third parties or with group companies as included in item 13 of the specimen income statement in the Chart of Accounts (accounts 661, 662, 664 and 665), in other words, (i) interest on debentures and bonds; (ii) interest on debts; (iii) dividends on shares that are financial liabilities; and (iv) interest on discounted notes and factoring transactions, including the issue or transaction costs of operations and, among others, the implicit interest associated with the transactions concerned.

    They do not include, however, (i) costs included in the value of assets or (ii) those resulting from updating provisions.

  - The finance income item for these purposes comprises the income from debt securities and the income from loans which are included in item 12 of the specimen income statement (accounts 761 and 762).

- An analysis of the following specific cases of finance costs and income that are not recognized for accounting purposes as such:

  - Loan impairment expense: the portion of the loan impairment expense that relates to interest earned and not collected is affected by this limit.

  - Foreign exchange gains and losses and hedge accounting: these are not generally included, unless they are directly related to the debt, in other words, where in the case of foreign exchange gains or losses or the effects of the hedges that have been included on the income statement and result from borrowing, even if they have not been recognized for accounting purpose as finance costs or income according to the above definition.

  - Silent participation agreements (*cuentas en participación* in Spanish): the participation of the silent partner, which is recognized for accounting purposes as debt, is treated as a financial asset and, therefore, the costs or income relating to that partner must be treated as finance costs or finance expense (and will not therefore be part of operating income).

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- Finance income that is recognized for accounting purposes as operating income: any finance income that forms part of operating income (by being included in revenue) will not be included in operating income for the purposes of determining the limit and will reduce finance costs for the period (to determine the net finance costs figure). This rule will apply, for example, to holding companies (in relation to their finance income from the financing of affiliates) or to certain concession companies (in respect of the finance income derived from the portion of the price under the concession agreements, recognized as a collection right).

2. DEFINITION OF OPERATING INCOME

Article 20 sets out the method for calculating operating income for these purposes, by providing that operating income:

- *Will be determined on the basis of results from operations in the income statement for the period determined in accordance with the Commercial Code and other accounting implementing regulations,*

- *by eliminating the amortization/depreciation expense, the allocation of subsidies for nonfinancial fixed assets and others, impairment expense and gains/losses on the disposal of fixed assets, and*

- *adding finance income from investments in equity instruments, provided they relate to dividends or shares in the income of entities in which, either the direct or indirect ownership interest is at least 5%, or the value of the ownership interest is higher than 6 million euros, unless those investments have been acquired with debt and the finance costs on that debt are not deductible under article 14.1.h) of this Law.*

On determining operating income, the Ruling provides as follows:

- In the case of holding companies, where their operating income already includes the dividends on these investments (as revenue), they must not be added twice.

- The exclusion of dividends from companies acquired with debt that does not give entitlement to deduct finance costs, under the provisions in article 14.i.h) of the Law, does not apply where those debts have already been paid off.

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3. FUTURE USE OF NET FINANCE COSTS THAT HAVE NOT BEEN DEDUCTED OR OF UNUSED OPERATING INCOME

- That same article 20 states that *the net finance costs that have not been deducted can be deducted in the tax periods ending in the immediately following successive 18 years, together with those from the tax period concerned, and subject to the limit provided in this subarticle*.

  The Directorate-General of Taxes takes the view that the order in those subsequent periods will be the following:

  - First, the net finance costs for the tax period concerned will be deducted; and

  - Then, if the limit of 30% of operating income or of one million euros in the period has not been exceeded, as applicable, taxpayers can use, up to the limit and without going above it, the net finance costs from prior periods that were not deducted because they were above 30% of the operating income for the period in which they were incurred.

- Moreover, article 20 of the revised Corporate Income Tax Law provides that *where the net finance costs for the period are below the limit set out in subarticle 1 above* (30% of operating income) *the difference between that limit and the net finance costs for the tax period shall be added to the limit provided in subarticle 1 above, with respect to the deduction of net finance costs in the tax periods that end in the five immediately following successive years, until that difference is deducted.*

  Therefore:

  - This difference from prior years, meaning the amount by which the net finance costs fall short of 30% of operating income, can be used in the following five years, in addition to the limit for the period and after that period.

  - If, however, the net finance costs for a period are below one million euros, the difference with respect to that one million euro figure cannot be used in future periods.

  - Give that in a given period net finance costs can be deductible up to an amount of one million euros, the deductible amount can be attained by adding to the net finance costs for the period, the net finance costs not deducted in prior years up to the limit of one million euros.

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4. SPECIFIC RULES FOR TAX GROUPS

The Ruling of the Directorate-General of Taxes contains a series of rules relating to the application of this limit in consolidated tax groups. These rules will require groups to keep very close track of the net finance costs deducted by the group, of the finance costs that have yet to be deducted and of their allocation to the companies in the group by reference to their generation and to their use.

- Computation of net finance costs and of operating income for the tax group as a whole.

  Article 20 of the Law states that *in the case of companies in a consolidated tax group, the limit set out in this article shall refer to the consolidated group.* Therefore, the net finance costs of the tax group will have to be taken subject to the limit of 30 percent of the operating income of the tax group, per the consolidated financial statements of the tax group, or to the limit of one million euros, a single limit for the tax group.

  This means that to determine the net finance costs and the operating income, the required eliminations and inclusions will have to be made, so as not to include the finance costs and finance income among companies in the same tax group and not to include in the group's operating income the results from internal operating activities.

- Distribution among the group companies of the amount of net finance costs generated individually.

  After the net finance costs deductible for the tax group as a whole have been determined, they have to be distributed among the various group companies so that they can be reported on their individual returns. Therefore:

  - If the group's net finance costs are below the limit of 30% of operating income or of one million euros, they will be deductible in full by the group, and therefore each company will deduct their respective finance costs in determining their individual tax base.

  - If those net finance costs are above the limit of 30% of operating income or of one million euros, a portion of the costs will not be deductible by the tax group, and that portion has to be distributed among the group companies for the purpose of determining their individual tax base. This distribution will be made as follows:

    - It will be distributed, in principle, only among those companies whose individual net finance costs have gone above those limits taken individually, after making the eliminations and inclusions required by reason of belonging to the tax group, and this will be done in proportion to all excess amounts.

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- If the group's nondeductible net finance costs are higher than the nondeductible net finance costs of each company, that excess will be distributed among all the companies in proportion to their net finance costs.

- Finance costs that have not been deducted or unused operating income at companies joining the tax group:

  - Where a company joining a tax group has finance costs carried forward for deduction in subsequent years, those finance costs will be subject to a double limit: the limit for the tax group and the limit for the company individually, in this last case after the eliminations and inclusions required by reason of belonging to the tax group have been made.

    If there are net finance costs carried forward for deduction in subsequent years, generated by the group itself or by a company before it became part of the group, they can be used in the order chosen by the taxpayer, after deducting the net finance costs for the period.

  - Where a company included in a group has unused operating income carried forward from prior years, that income can be used only by that company itself after the group's nondeductible net finance costs have been distributed among the group companies.

- Allocation of the net finance costs that have not been deducted and of the unused operating income where a company leaves the tax group or the group is dissolved.

  The company leaving the tax group will acquire the right to deduct those net finance costs that have not been deducted and were allocated to it under the rules mentioned above, and it will also acquire the portion of operating income that has not been used to the extent to which it contributed to the generation of that income.

- Article 20 of the Law, amended by Royal Decree-law 20/2012, provides that the limit provided in that article does not apply to credit institutions and to insurance firms[2]. The Ruling only refers to credit institutions, although we consider that its provisions in relation to credit institutions must also be taken to apply to insurance firms and any other enterprises which, in accordance with Royal Decree-law 20/2012, will be treated as credit institutions for these purposes.

  Where these credit institutions (and/or insurance firms) are part of a consolidated tax group with other enterprises that are not treated as such, *the limit laid down in this article must be calculated by reference to the operating income and the net finance costs of those other enterprises.*

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[2] Royal Decree-law 20/2012 provides that enterprises whose voting rights are directly or indirectly held wholly by credit institutions and whose only activity consists of issuing and placing on the market financial instruments to shore up the regulatory capital and the financing activities of those institutions, will be treated as credit institutions for these purposes.

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- For these cases, the Directorate-General of Taxes has clarified that the calculation of these limits for these enterprises which are not credit institutions or insurance firms will not include either the finance costs or the finance income among companies in the tax group that are eliminated as part of the consolidation process for tax purposes (including those transactions in which the credit institutions or the insurance firms belonging to the tax group have taken part).

- The calculation of the operating income of enterprises in the consolidated tax group that are not credit institutions or insurance firms must be made after the required eliminations and inclusions have been made in relation to all the companies in the tax group (including the credit institutions or insurance firms belonging to the tax group).

- The above rules may affect the calculation of the deductible impairment of investments in affiliates in the same tax group. Article 12.3 of the revised Corporate Income Tax Law provides that the deductible impairment will be determined by comparing the equity of the affiliate at the beginning and the end of the tax period, clarifying that *for these purposes, equity will be determined in accordance with the Commercial Code and other accounting implementing regulations, and that difference must be adjusted, as required, by the expenses for the period that are not tax deductible in accordance with the provisions in this Law.*

  The Directorate-General of Taxes addresses how the limit in article 20 must be taken into account to determine the nondeductible expenses of the affiliate where it is part of the same tax group to apply the rule in article 12.3. The view it takes is that the fact of it belonging to the group must be taken into account and, therefore, the result of the redistribution of the net finance costs discussed above.

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