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Spain and EU tax update 2016: special focus on LATAM cross-border implications

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Brief notes on the State Aid cases in EU

- **Tax ruling practice in Spain**
  - Transparent and regulated proceedings. Public Rulings.
  - Private Letters are not permitted. Advance pricing agreements (APAs) not widely used.
  - 20 July 2015, Margrethe Vestager: "*I do not see any problem with Tax Rulings in Spain*"

- **Outcome of past State aide cases in Spain**
  - Financial goodwill deduction in international M&A
  - Corporate "tax holidays" in Basque Country region
  - Tax lease schemes

New Spanish patent box regime

- Introduction in Spain of the modified *nexus approach* considered by the OECD under Action 5 (counteracting harmful tax practices) of the BEPS Action Plan and supported by the European Union.

- Before July 2016.
  - 60% of net qualifying income derived from the licensing or the transfer of certain intangible assets (patents, designs, formulas and know how) is exempt from corporate income tax in Spain .

New Spanish patent box regime

- After July 2016 (patents, designs, formulas, know how)
  - 60% exemption is limited by a ratio resulting from the following quotient:
    - 130% of the expenses incurred by the licensing entity directly related with the creation or development of the IP assets, including those derived from the outsourcing to third parties in this regard; divided by
    - 100% of the expenses incurred by the licensing entity related with the creation of the IP, including those derived from the outsourcing, and if applicable, from the acquisition of such IP
  - This exemption would also apply to the income from the transfer of the qualifying IP.
  - Spanish taxpayer no longer required to incur in at least 25% of the cost of the IP asset

New Spanish patent box regime

- After July 2016

  Additional requirements for the 60% exemption:

  1. The licensed IP assets should be used within an economic activity (not services to related licensing party)
  2. The licensed entity is not resident in a blacklisted jurisdiction.
  3. Additional services need to be separately considered in the agreement.
  4. The licensing entity should have the accounting registers in order to differentiate income and expenses related to each IP asset. Income to be reduced would be considered net of depreciation and of those expenses directly related to such asset on the relevant period.

- Transitory tax regime

New participation exemption: impact on ETVEs

- ✓ **Dividends and gains** from both domestic and foreign subsidiaries (including also branch and PE distributions received from abroad) are tax exempt (and will be remitted to foreign investors free from taxation in Spain) under new requirements:
  - 5% or €20M cost (specific rules apply to intermediate holdings)
  - 1 year holding period (by group, etc)
  - Sub: subject to 10% statutory rate or enjoying protection of tax treaty
  - No business activity test (but beware of new CFC rules)

- ✓ Exemption of **interest received from profit sharing loans**, but anti-hybrid limitations may apply
- ✓ It is fully compatible with operative activities, R&D and shared service centers in Spain
- ✓ Potential listing in Spanish and foreign stock markets (CEMEX, AIG, etc)
- ✓ Developments on Juros (JsCP) from Brazilian subsidiaries

New anti-abuse provisions in EU directives

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EC Parent-Subsidiary Directive (“**PSD**”)

- Mechanism for the elimination of double taxation of dividends and other profit distributions within the EU.

  – July 8th, 2014: **Anti-hybrid rule:** Member States should tax profits from hybrid instruments to the extent that such profits are deductible at the level of the subsidiary.

  – January 27th, 2015: **General Anti Avoidance Rule (EU GAAR):** Member States shall not grant the benefits of the PSD to an arrangement or a series of arrangements that, having been put into place for the main purpose or one of the main purposes of obtaining a tax advantage which defeats the object or purpose of the PSD, are not genuine having regard to all relevant facts and circumstances.

    - An arrangement may comprise more than one step or part.
    - **Need for valid commercial reasons which reflect economic reality**.
    - It does not preclude domestic legislation or tax treaties

PSD - summary of situation (January 2016)

- Spain already introduced an anti-abuse provision and an anti-hybrid rule.

- Countries with new legislation or pending to be passed as of January 2016
  - Denmark, Finland, Estonia, France, Ireland, Lithuania, Luxembourg, Poland, Romania, Slovakia, Slovenia, Sweden, Bulgaria, Croatia, Cyprus, Hungary, Portugal, The Netherlands.

- Countries with no need of new legislation
  - Austria, ¿Belgium?, Czech Republic, Germany, Greece, Italy, Malta, UK

EC Interest and Royalty Directive (“**IRD**”)

- Mitigates double taxation of interest and royalty payments amongst associated EU companies.
  - November 11th, 2014: **proposal of amendment:** Updated list of companies, lowers threshold (10%) and includes indirect holding to consider “associated” Co, and intends to grant benefits or exemption only if payment is not exempt in the recipient.
  - January 27th, 2015: **proposal of EU GAAR:** a main purpose test similar to the one for the PSD may be introduced to the IRD

    - Discussed by ECOFIN in September 2015
    - Complexity of implementation is noted

The EU Action Plan and anti-avoidance package

EU Action Plan

- On 17 June 2015, the Commission adopted an Action Plan for fair and efficient corporate taxation in the EU.

- It sets to reform the corporate tax framework in the EU, in order to tackle tax abuse, ensure sustainable revenues and support a better business environment in the Single Market.

- 5 Key Areas for Action have been identified:

    1. Re-launching the Common Consolidated Corporate Tax Base (CCCTB)
    2. Ensuring fair taxation where profits are generated
    3. Creating a better business environment
    4. Increasing transparency
    5. Improving EU coordination

*source: http://ec.europa.eu/taxation_customs/taxation/company_tax/fairer_corporate_taxation/index_en.htm

EU Anti Tax Avoidance Package

- 28 January 2016 – EU Commission published Anti Tax Avoidance Package containing measures to address aggressive tax planning, increase tax transparency and create a level playing field within the EU
- Goal is for EU Member States to adopt a coordinated action against tax avoidance and ensure that companies pay tax wherever they make their profits in the EU

- Package includes:
  1. Proposal for an Anti Tax Avoidance Directive;
  2. Recommendation on Tax Treaty Issues;
  3. Proposal for a Directive implementing the OECD Country by Country Reporting (CbCR); and
  4. Communication on an External Strategy (incl. a new EU process for listing third countries that refuse to play fair)

Goal Anti Tax Avoidance Directive

- Implement some of the final recommendations of the OECD Base Erosion and Profit Shifting (BEPS) project into Member States’ national laws
- Align tax laws of the 28 EU Member States to fight aggressive tax practices efficiently and effectively

How? By imposing legally-binding measures to block the most common methods used by companies to avoid paying tax

The Anti Tax Avoidance Directive will apply to all taxpayers which are subject to corporate tax in a Member State, including permanent establishments (PEs) of entities resident in a third (non-EU) country

Content Anti Tax Avoidance Directive

Proposal contains various rules in 6 specific fields:

1. Deductibility of interest
2. Exit taxation
3. Exemption of low taxed profits of a subsidiary or PE (switch-over clause)
4. General anti-abuse rule (GAAR)
5. Controlled foreign company (CFC) rules, and
6. Framework to tackle hybrid mismatches

NOTE: the following is based on the latest draft proposal issued by the Presidency of the working group, dated 15.4.2016

1. Deductibility of interest

- Limitation of deduction of net interest expense to the higher of **30% of EBITDA** or **€ 3 million** (also applicable to groups).
- This does not include "standalone" entities or certain infrastructures projects.
- Carry forward possible for excess interest expenses and for excess 30% of EBITDA. Potential carry back (limited).
- Exemptions:
  - Member States can allow taxpayers to deduct net interest expense in excess of 30% of EBITDA if the taxpayer can demonstrate that the ratio of its equity over its total assets is equal or higher than the equivalent ratio of the group in which its accounts of the taxpayer are consolidated under IFRS or US GAAP. This exception is subject to an anti-stuffing rule
  - Not applicable to financial undertakings, such as banks, insurance companies, pension funds and certain investment funds
  - Previous third party loans

2. Exit taxation

- Exit taxation in country of origin on the difference between market value and tax value

- Triggered in case of
  - transfer of assets from the head office to a PE located in another Member State or in a third country;
  - transfer of assets from a PE in a Member State to its head office or another PE located in another Member State or third country;
  - transfer of tax residence to another Member State or third country (except when the assets remain connected with a PE in the Member State of origin); or
  - transfer of the business carried out in a PE out of a Member State

- Right to defer “exit tax” if move to a member of the EEA Agreement

3. Switch-over clause

- Member States will be obliged to deny an exemption from corporate tax with respect to distributions of profits and proceeds from the sale of shares in **low taxed** entities that are resident in, and PEs that are located in, third (non-EU) countries

- An entity or PE is regarded low taxed when that entity or PE is subject to a statutory corporate tax rate lower than 40% of the statutory corporate tax rate that would apply in the Member State of the taxpayer receiving the income. Attention to tax treaty partner exception (section 6.1.2).

- A credit will be available for tax that was paid by the low taxed subsidiary or PE

4. General Anti Abuse Rule

- GAAR should now be applied to the entire domestic corporate tax laws of the Member States (in line with Parent / Subsidiary situations)

- Under the GAAR, **non-genuine arrangements** or series thereof that are put in place for essential purpose of obtaining a tax advantage that defeats the object or purpose of the applicable law should be ignored for the purposes of determining the corporate tax liability

- Arrangements or series thereof shall be regarded as non-genuine to the extent that they are not put into place for valid commercial reasons which reflect economic reality

- Tax liability calculated in accordance with national law.

5. CFC Legislation

- EU Member States required to implement CFC rules.
- CFC rules should be applied to non-distributed income of entities if:
  - a taxpayer by itself or together with associated enterprises, holds directly or indirectly more than **50% of capital or voting rights** or is entitled to receive more than 50% of the profits of an entity;
  - profits are subject to an **effective tax rate lower than 50%** of the effective tax rate that would have been applied in the Member State of the taxpayer; and
  - more than 1/3 of the income accrued to that entity falls within one or more of the **income categories** listed in the Anti Tax Avoidance Directive (i.a., interest, dividends, royalties, income from insurance activities and income from related party services)

6. Hybrid mismatches

- Applies to the treatment of hybrid mismatches created by **entities or instruments** that may give rise to double deduction or deduction/non-inclusion situations:

  - If double deduction, Member state of the parent shall deny deduction
  - If deduction with non-inclusion, Member state of the payer shall deny deduction

- The scope is no longer limited to hybrid mismatches between Member States

Recommendations

- Member States to implement **Limitation on Benefit rules** in their tax treaties

- Member States to implement following **Principle Purpose Test**:

"Notwithstanding the other provisions of this Convention, a benefit under this Convention shall not be granted in respect of an item of income or capital if it is reasonable to conclude, having regard to all relevant facts and circumstances, that obtaining that benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit, unless it is established that it reflects a genuine economic activity or that granting that benefit in these circumstances would be in accordance with the object and purpose of the relevant provisions of this Convention."

Impact ?

The Anti Tax Avoidance Directive is tabled for approval by the European Council on 25 May 2016. It needs to be approved unanimously by all 28 Member States. Feasible?

Political pressure to amend tax treaties?

Spanish tax treaties: the protocol with Mexico

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Spanish TT and BIT network with LATAM

Treaties in force (17)

- ✓ Argentina *
- ✓ Barbados
- ✓ Bolivia *
- ✓ Brazil
- ✓ Chile *
- ✓ Colombia *
- ✓ Costa Rica *
- ✓ Cuba *
- ✓ Dominican Republic *
- ✓ Ecuador *
- ✓ El Salvador *
- ✓ Jamaica *
- ✓ Mexico *
- ✓ Panama *
- ✓ Trinidad and Tobago *
- ✓ Uruguay *
- ✓ Venezuela *

Under negotiation (4)

- ✓ Peru (signed) *
- ✓ Paraguay *
- ✓ Guatemala *
- ✓ Honduras *

**Countries that have a BIT with Spain. Bolivia has cancelled the existing BIT but announced the negotiation of a new instrument to protect investments*

Summary of certain Spanish TT with LATAM

	Dividends	Gains	Interest	Royalties	Servicies
Mexico	5-15% (new 0-10%)	0-25% (new 0-10%)	10-15% (new 4.9-10%)	0-10%	0%
Brazil	0% (domestic law)	15% (0% indirect)	15% (tax sparing)	10-15% (tax sparing)	0-10%
Colombia	0%	0%	10%	10%	0%
El Salvador	0%	0%	10%	10%	0-10%
Panama	0%	0%	5%	5%	0-7,5%
Costa Rica	5%	0%	0-5-10%	10%	0%
Ecuador	15%	0%	0-5-10%	5-10%	0%
Chile	8% after tax credit	16%	15%	10%	0%
Rep. Dom.	10% or domestic law	0%	10%	10%	0-10%

Note: this is a general summary. It assumes a substantial interest in accordance with the applicable tax treaty. Interest paid to financial institutions is usually exempt from WTH. Real estate investments may require additional planning. Tax treaty with Brazil confers a tax credit (25-20%) that exceeds actual WTH paid (tax sparing clause)

MEXICO: New trends & BEPS influence

- Promotion of economic relationship: new flows and more balanced situation

- Conclude a tax treaty for income and wealth taxes that impedes:

  a) opportunities for non-taxation (e.g. stateless income)

  b) reduced taxation through tax evasion o elusion (including abuses of law or abuse of tax treaties by residents of third countries indirectly benefiting from the provisions of the tax treaty).

Residency and associated parties

- Clarification for state and local subdivisions

- Regulation of dual residency of corporations: from seat of effective management to competent authority agreement based on (i) activity of managing directors and senior staff, (ii) day-to-day activities and management, (iii) other equivalent factors

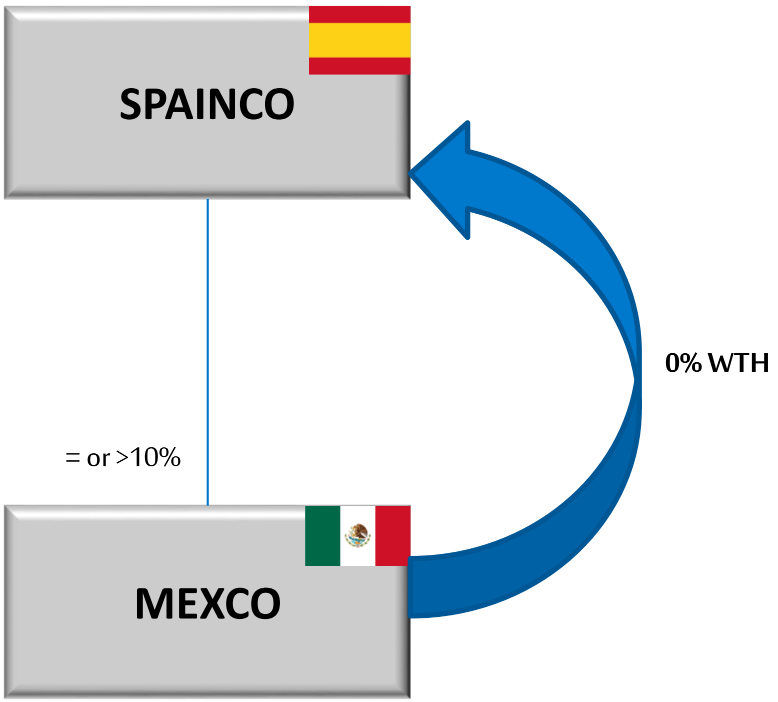
- No changes as regards PE definition, except for oil and hidrocarbons activites. Clarification would have been helpful, particularly taking into account new protocol establishes that a “fix base” is to be treated in accordance with PE principles

- Regulation of secondary adjustment in case of related or associated companies

Dividends

	Current Mex-Spain Tax Treaty	Amended Mex-Spain Tax Treaty
Withholding tax rate	**5%** if the beneficial owner is a company (except for partnerships) with <u>direct participation of at least 25%</u>	**0%** if beneficial owner is: a) a company with capital totally or partially divided in shares or interests and with <u>direct participation of at least 10%</u>, or b) a pension fund
	15% in all other cases	10% in all other cases

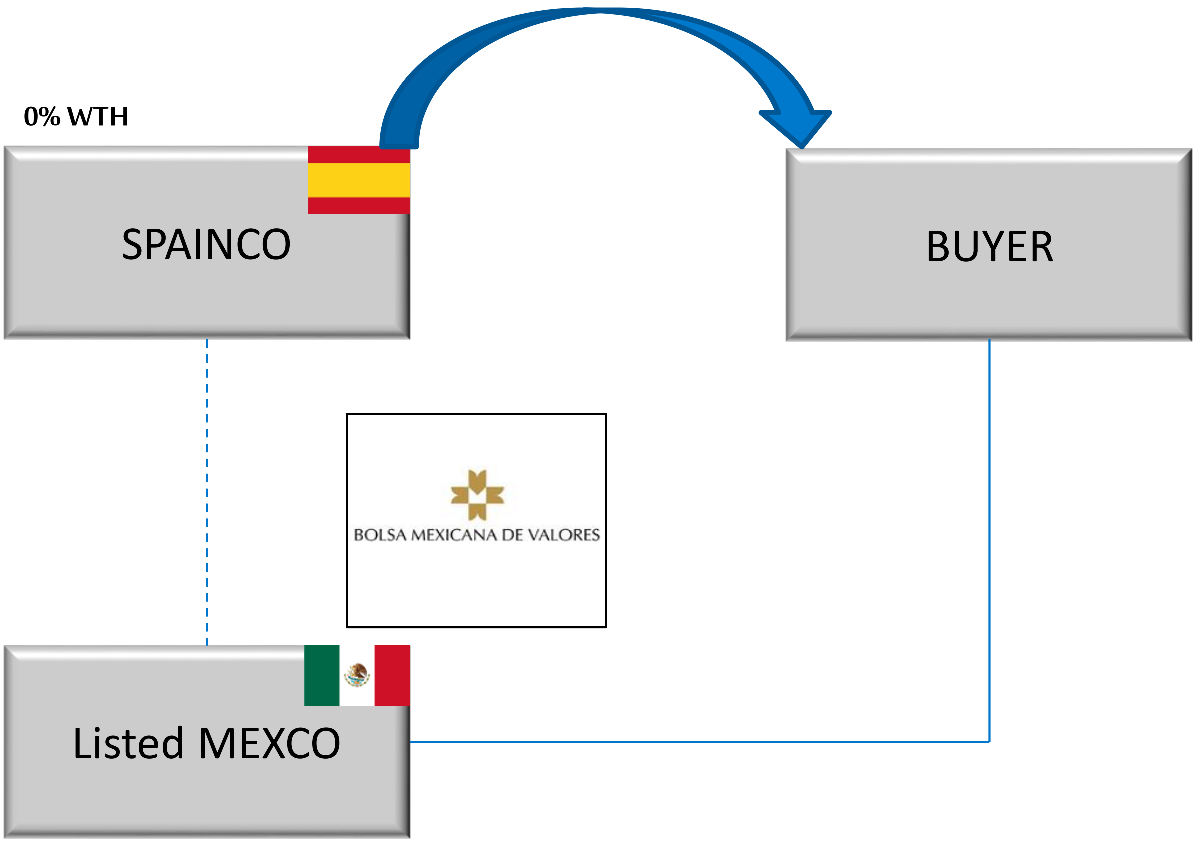
Dividends, as amended



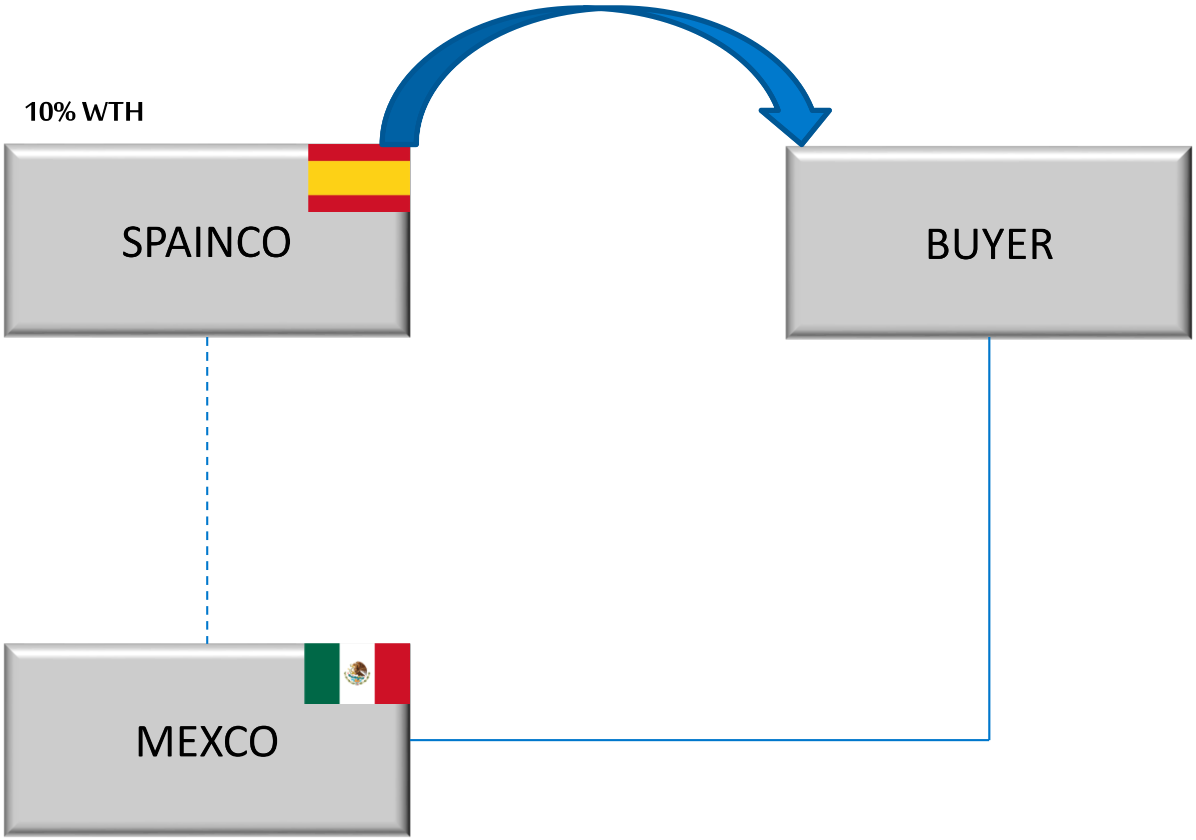
Capital gains

	Current Mex-Spain Tax Treaty	Amended Mex-Spain Tax Treaty
Exemptions	0% if gains derive from a participation <25% 0% if gains derive from a participation >25% that has not been held for more than 12 months before alienation 0% "Indirect" sales of second tier subs (not real estate companies)	0% if seller is: a) a financial institution; b) an insurance entity; c) a pension fund, or d) gains from sales of regularly traded shares or interests (not SOCIMIs) e) "Indirect" sales of second tier subs (not real estate companies)
Withholding tax rate	25% when gain not exempt (if interest held is >25%) (25% or 35% for certain real estate companies?)	10% in all other cases (for direct dispositions) (25% or 35% for certain real estate companies?)

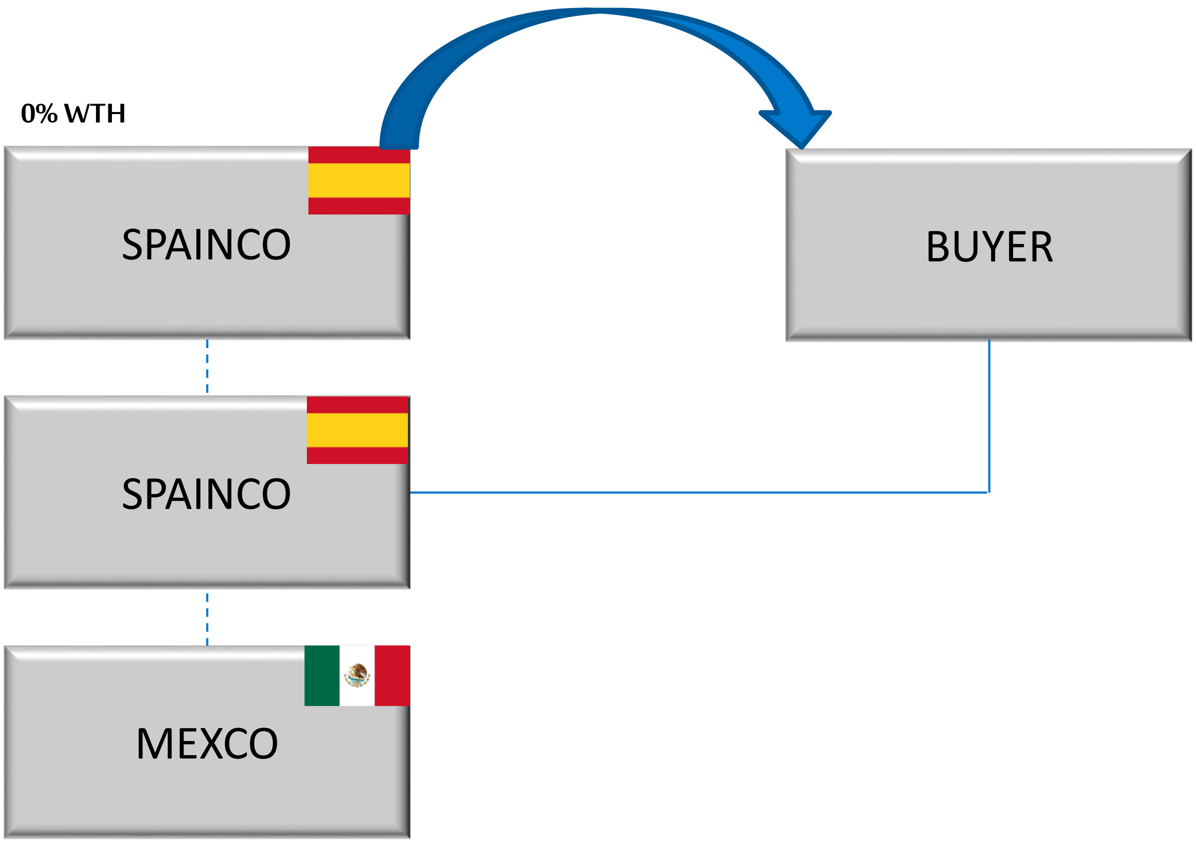
Capital gains of listed shares



Direct gain of non-listed shares



Indirect gain of non-listed shares



Capital gains and exit tax

- Transfer of IP remains subject to provisions of article 12
- Other assets not taxable at source

- <u>New exit tax for individuals:</u>

  a) Individual residing in state A (e.g. Mexico) for 5 or more years moves to state B (e.g. new tax residency in Spain)
  b) State A can tax the part or amount of gain derived from a sale of shares corresponding to the period of residency in state A based on domestic legislation
  c) In those cases, state B will not tax the amount of gain taxed by state A.

Corporate reorganizations

- New wording includes additional requirements to “defer” taxes in group reorganizations:
    1. Transfer of shares within corporate group
    2. Exchange of shares: must receive shares in acquirer, acquirer subs or acquirer parent company
    3. 80% threshold (capital and voting rights)
    4. Acquirer resident in Mexico or Spain or country with extensive exchange of information
    5. Future gain = original cost + cash or additional remuneration. However, cash and others may be taxable at source.
- Prior wording was referred to transfer of assets by merger, split or exchange in context of a reorganization of entities held by same group of shareholders

Interest

	Current Mex-Spain Tax Treaty	Amended Mex-Spain Tax Treaty
Exemptions	0% if a) Recipient or payer is other government or local divisions b) Loans for 3 or more years to promote exports	0% if a) Recipient or payer is other government, its Central Bank or local divisions b) Loans for 3 or more years to promote exports c) Beneficiary is a pension fund
Withholding tax rate	10% if beneficiary is a bank 15% all other cases	4.9% in case of banks and other financial institutions (including insurance companies) and listed bonds 10% all other cases

Other relevant provisions

- Request for Competent Authority's MAP: 3 years
- New wording for exchange of information (including protection for trade secrets and others) and mutual assistance
- "Most favored nation" clause for interest and royalties if Mexico signs better tax rates with OECD or EU members
- Technical assistance is business profit (art 7 or 14)

- **New GAAR based on PPT:**

  1. Compatibility with domestic anti-abuse provisions
  2. Denial of TT benefits if the goal if a main goal of the transaction is to obtain a TT benefit, unless it is deemed in accordance with the purpose of the TT
  3. Compatibility with CFC rules, thin cap and REFIPRE

Q&A

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