



MERGERS AND ACQUISITIONS

Spain

Taxation of Cross-Border
Mergers and Acquisitions

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TAX

Spain

Introduction

The Spanish tax environment for mergers and acquisitions (M&A) has changed fundamentally in recent years, and continues to change, in response to a worsening economic climate, perceived competitive pressures from other European Union (EU) countries, and challenges to existing Spanish (laws) under EU non-discrimination principles.

This chapter begins by explaining how these changes are likely to affect the approach to transactions. The chapter proceeds by addressing three fundamental decisions faced by a prospective purchaser.

- What should be acquired: the target's shares, or its assets?
- What should be used as the acquisition vehicle?
- How should the acquisition vehicle be financed?

Tax is, of course, only one part of transaction structuring. Company law governs the legal form of a transaction, and accounting issues are also highly relevant when selecting the optimal structure. These areas are outside the scope of this book, but some of the key points that arise when planning the steps in a transaction plan are summarized below.

Most transactions performed in Spain are covered by Royal Legislative Decree 4/2004 dated 5 March 2004, which embeds in the Spanish tax system the tax regime applicable to mergers, splits and other reorganization transactions covered in EU directives. This tax regime, which can be complex, should be taken into consideration in each phase of the acquisition. Specific anti-avoidance provisions may apply, and local advice should be sought.

Recent Developments

The following summary of recent Spanish tax changes is based on current legislation up to 30 September 2009. Since the last edition of this book, the main modifications for M&A purposes are:

- amendments to corporate income tax (CIT) legislation as a consequence of the adaptation of Spanish accounting rules to EU legislation by

means of the approval of Law 16/2007 dated 4 July, on the reform and adaptation of mercantile accounting rules aimed at their international harmonization, based on EU rules;

- new tax credits established in the CIT Law;
- amendments relating to tax havens located within the European Union;
- amendments to Capital Tax Law;
- adaptation of Value-Added Tax Law to European Court of Justice (ECJ) judgments; and
- new transfer pricing documentation requirements.

Amendments Derived from the New Accounting Rules

Intangible assets depreciation rules

Intangible assets with an indefinite life may not be depreciated for accounting purposes, but for tax purposes they can be depreciated at a 10 percent each year, provided they have been acquired from non-related entities.

Goodwill Impairment Rules

For accounting purposes goodwill can be depreciated on an impairment test basis. For tax purposes it can be depreciated on a straight-line basis at a maximum rate of 5 percent annually providing:

- the goodwill has been acquired by non-related entities; and
- a non-distributable reserve has been created for the amount considered tax deductible.

Additionally, the Spanish Tax Directorate has argued that the non-distributable nature of the reserve should also apply to goodwill arising on a merger under the tax-neutral regime. But the issue is not clear cut.

New Tax Credits Established in the CIT Law

New tax credits are available on income arising from the assignment or lease of rights to use or exploit patents, drawings or models, plans, and formulae or secret procedures, and to income obtained from the assignment of rights on information related to industrial,

commercial, or scientific experience. Income arising from the transfer of know-how in general might benefit from this special tax regime.

The regime provides a CIT deduction of 50 percent of the lease income derived from certain intangible assets. The deduction applies to income obtained up to and including the tax period in which the income arising from the assignment of each qualifying asset exceeds six times the cost of the leased asset.

There is also a new tax incentive for investment in and maintenance of employment; namely free depreciation for CIT purposes for investments made in fixed assets and for investments made in real estate during 2009 and 2010 that are linked to the maintenance of employment

Amendments Relating to Tax Havens Located within the European Union

Certain limitations regarding tax havens (that is, participation exemption for dividends and capital gains obtained from non-resident entities, controlled foreign company [CFC] rules, and tax credits to avoid international double taxation) have been changed, to ensure such limitations will not be applicable to tax havens within the European Union when the subsidiaries were located in such jurisdictions for valid business reasons

Amendments to Capital Tax Law

Since, 1 January 2009, capital tax should not be triggered on certain restructuring transactions, irrespective of the application of the tax-neutrality regime.

Other changes to capital tax which could affect M&A matters should also be taken into account:

- the transfer of a corporation's place of effective management or registered office to Spain will no longer be subject to capital tax when place of effective management or registered office was previously located in another EU Member State; and
- the establishment of Spanish branches will only be subject to capital tax when the foreign company establishing the branch is located outside the European Union.

Adaptation of Value-Added Tax to ECJ Judgments

Prior to 1 January 2009, VAT Law established that transactions carried out under the tax-neutrality regime

for mergers, spin-offs, and exchanges of shares were not subject to VAT and the transfer of a whole business was not subject to VAT.

Since 1 January 2009, the cases mentioned above have disappeared and VAT Law has established that the transfer of a set of tangible elements and, as the case may be, intangible elements which, belonging to taxable person's business or professional asset, constitute an independent economic activity capable of carrying on an business or professional activity on their own, regardless of special tax regime to that transmission will be of application.

In this sense it would be advisable that the VAT Law expressly denies this VAT regime (not subject to VAT) to taxable person's business or professional who transfer leased elements which develop their activity without human and material resources (branch of activity).

In this sense, the Spanish tax authorities has considered in a binding tax ruling that in some cases, a merger carried out under the tax neutrality regime could be subject to VAT in certain circumstances.

New Transfer Pricing Documentation Requirements

The Law 36/2006 established a new transfer pricing regime that obliged taxpayers to prepare and, on request of the tax authorities, present their transfer pricing documentation to verify that their related-party transactions had been priced in line with the arm's length principle, and to explain which valuation method(s) were chosen and what comparability criteria were applied.

Law 36/2006 deferred an itemization of what the transfer pricing documentation should contain until a later date. The details were officially published on 18 November 2008, in Royal Decree 1793/2008. As stipulated by Law 36/2006, the regulations became enforceable three months enactment, that is, from 19 February 2009.

From this date the new penalty regime introduced by Law 36/2006 relating to the formal requirements of the documentation also become enforceable and may apply to both the adjustments performed and any lack of support for related-party transactions.

Asset Purchase or Share Purchase

In general terms, a transaction can be performed as a share deal, when the shares in the target entity are sold, or as an asset deal, in which case the assets (and

normally the associated liabilities) are the objects of the transaction.

Although the transfer of shares might allow the seller to mitigate its capital gains tax through participation exemption rules for companies, or capital time-based gains reliefs in the case of individuals, the purchaser would not be able to step up the tax basis in the assets of the target and will inherit any hidden capital gains and contingencies. On the other hand, the sale of assets would normally produce a taxable capital gain for the selling company (30 percent CIT rate for 2008 onwards), which might be difficult to mitigate (although some tax benefits might be applicable such as the reinvestment tax credit). However, the acquiring entity will have a stepped-up tax basis.

The purchaser of shares will assume the liabilities of the company acquired (although they might be covered by indemnities in the sale and purchase agreement), while the acquirer of individual assets does not assume the tax risks of the selling company unless the acquisitions made by one or several persons or entities continue an ongoing concern. However, in the case of an asset deal in which a complete business unit is transferred, the liabilities connected to such a business are also transferred, although, in this case, the purchaser might limit its liability by obtaining a certificate from the Spanish tax authorities showing the tax liabilities and debts. The liabilities transferred would then be limited to those listed in such a certificate.

Purchase of Assets

Tangible Assets

Most tangible assets, with the exception of land, can be depreciated for tax purposes, provided the depreciation is based on the asset's recorded historic cost or on a permitted legal revaluation, and spread over the period of its useful economic life.

Special rules establish the specific depreciation percentages in force, which depend on the type of industry and assets involved. A maximum percentage of annual depreciation and a maximum depreciation period are established for each type of asset.

Intangible Assets

Intangible assets with finite useful lives are amortized depending on useful life. The tax deductibility of such amortization is limited to 10 percent of its value.

Intangible assets with indefinite useful lives are not amortized, but are subject to an annual impairment

tests. Irrespective of the result of such an impairment test, the value of the intangible asset may be deducted from the taxable base with an annual limit of 10 percent.

Goodwill

The premium paid by a purchaser of a business as a going concern could be due to a higher value of the assets acquired or due to the existing goodwill. If certain requirements are met, goodwill can be written down for tax purposes at a maximum annual depreciation rate of 5 percent. The price allocated to each asset would be tax depreciated according to the individual asset's depreciation profile.

From a tax perspective, as a general rule, the value of the goodwill may be deducted from the taxable base with an annual limit of 5 percent of its book basis by adjusting the accounting result, if the requirements established by the CIT Law are met. A non-distributable legal reserve should be booked by the company for an amount at least equal to the goodwill tax depreciation. (See Recent Developments.)

Depreciation

Most tangible assets, with the exception of land, can be depreciated for tax purposes, provided the depreciation is based on the asset's recorded historic cost or permitted legal revaluation, and spread over the period of its useful economic life.

Special rules specify maximum depreciation percentages and periods for specific industries and types of asset.

Depreciation rates higher than the officially established or approved percentages can be claimed as deductible expenses if the company obtains permission from the tax authorities, or can support the depreciation applied.

As a consequence of the enactment of new Spanish accounting rules, the depreciation of assets that are expected to be sold in less of 12 months is not permitted.

Tax Attributes

Pending tax losses and tax deduction pools are not transferred on an asset acquisition. They remain with the company or are extinguished. However, in certain cases, under the tax neutrality regime for reorganizations (such as mergers, spin-offs, contribution of a branch of activity, etc.) it may be possible to transfer such tax attributes to the acquiring company.

Value-Added Tax (VAT)

VAT is generally applicable to the supply of goods or services by entrepreneurs and professionals, as well as to EU acquisitions and the importation of goods by all persons. The standard rate is 16 percent, (the Law has been amended and the VAT rate from July 2010 onwards will be 18 percent).

Transactions not subject to VAT are:

- transfers of sets of tangible and, as the case may be, intangible elements that belong to taxable person's business or professional assets, and constitute an independent economic activity capable of carrying on an business or professional activity on their own, regardless of any special tax regime that may apply to such a transfer (see Recent Developments); and
- transfers of assets that cannot be physically delivered, such as credits and loans.

The purchaser may deduct the VAT paid on inputs from the VAT charged on outputs, and may claim a VAT refund if the VAT paid exceeds the VAT charged monthly or quarterly. However, the VAT paid on certain inputs, such as traveling expenses, gifts and passenger cars, among others, is non-deductible.

Transfer Taxes

The contribution of assets to a company as payment for the shares received on incorporation or capital increase, is subject to 1-percent capital tax, but notwithstanding, corporate reorganizations should not be subject to 1-percent capital tax in application of article 19 approved by Legislative Royal Decree 1/1993, dated on 24 September of transfer tax.

Stamp duty also applies to transactions, such as the sale of real estate, when the sale is subject to VAT and/or the taxpayer waives the VAT exemption on such transfer. There is compatibility between VAT and stamp duty

Sales of real estate exempt from VAT (that is, a second transfer of a building) are subject to a transfer tax at a rate of between 6 percent and 7 percent, unless certain requirements are met and the transferor waives the VAT exemption.

Purchase of Shares

Due Diligence Reviews

In negotiated acquisitions, the seller usually makes the target company's official books and tax returns available

to the purchaser for due diligence review. An important part of the due diligence process will be an in-depth review of the tax affairs of the potential target company by the advisers to the purchaser.

Local or State Taxes

There are no local or state taxes payable on the transfer of shares.

Tax Indemnities and Warranties

In the case of negotiated acquisitions, it is common practice for the purchaser to request the seller to provide indemnities or warranties for any undisclosed liabilities of the company to be acquired.

Tax Losses

Tax losses under Spanish Law can be carried forward up to a maximum of 15 years after their generation. Companies made decide how and when to offset losses during this period. Additionally, certain limitations exist to offsetting such tax losses.

In this sense, the amount of offset table tax losses shall be reduced by the amount of the positive difference between the value of shareholder contributions howsoever made in respect of the holding acquired and the acquisition cost of the holding, where the following circumstances exist:

- A majority of the capital stock or of the rights to share in the income of the entity has been acquired by a person or entity or by a group of related persons or entities after the end of the tax period to which the tax losses relate.
- The persons or entities referred to in the preceding Letter have a holding of less than 25 percent at the end of the tax period to which the tax losses relate.
- The entity has not performed any economic operations in the six months prior to the acquisition of the holding that confers a majority interest in the capital stock.

Transfer Taxes

Neither VAT nor transfer tax is payable on the transfer of shares, except in certain cases mainly involving the sale of shares as a means of selling real estate. In such cases, when more than 50 percent of the company's assets consist of real estate and the acquirer receives more than 50 percent of the company's voting rights directly or indirectly, the transfer of the shares will be subject to transfer tax at the 6-percent or 7-percent rate.

Stamp duty is not payable, but brokerage or notary fees, which are normally less than 0.5 percent of the price, are applicable.

Choice of Acquisition Vehicle

There are several potential acquisition vehicles available to a foreign purchaser and tax factors will often influence the choice.

Local Holding Company

This is the most common vehicle for transactions. There are two main types of limited liability companies: Sociedad Anonima (SA) and Sociedad de Responsabilidad Limitada (SL). In both cases the entity has its own legal status (legal personality). Each has a minimum share capital (EUR 60,000 for a SA and EUR 3,000 for an SL) and may have one or more shareholders. Both are governed by their own by-laws, which need to be approved on incorporation.

Foreign Parent Company

Spain does not charge withholding tax (WHT) on interest and dividends paid to EU recipients (see the EC Interest and Royalties Directive 2003/49/EC, and the Council Directive 90/435/EEC on the common system of taxation applicable in the case of parent companies and subsidiaries of different member states). Some tax treaties also reduce the WHT rates. If the acquirer resides in a country with which Spain has no tax treaty, it may want to consider making the acquisition through an intermediary company resident in a country that does provide treaty relief.

Non-Resident Intermediate Holding Company

If the foreign country taxes capital gains and dividends received from overseas, an intermediate holding company resident in another territory could be used to defer this tax and perhaps take advantage of a more favorable tax treaty with Spain. However, the purchaser should be aware that certain Spanish treaties contain treaty shopping provisions that may restrict the ability to structure a deal in a way designed solely to obtain tax benefits.

Local Branch

The target company's assets or shares can be acquired through a branch. Although branches are taxed in a similar way to resident companies, they have the advantage of not attracting WHT on remittance of profits abroad, provided the foreign company resides in a tax treaty country or in the European Union (with some exceptions).

Joint Ventures (and Other Vehicles)

Spanish partnerships engaged in business activities (Sociedad Colectiva or Sociedad Comanditaria) are treated as corporate taxpayers.

Choice of Acquisition Funding

A purchaser using a Spanish acquisition vehicle to carry out an acquisition for cash will need to decide whether to fund the vehicle with debt or equity, or even a hybrid instrument that combines the characteristics of debt and equity. The principles underlying these approaches are discussed later in the chapter.

Debt

The investment may be financed on either the local or a foreign market. No limitations apply to local financing provided the borrower is a Spanish resident. If the loan is granted by a non-resident, under the current exchange control system, the borrower must declare the loan to the Bank of Spain. Previously, the borrower had to obtain a number of financial operation (NOF) by filing the appropriate form (PE-1 or PE-2), depending on the amount of the loan.

The principal advantage of debt is the potential tax-deductibility of interest (see Deductibility of Interest later in the chapter), whereas the payment of a dividend does not give rise to a tax deduction. Another potential advantage of debt is the deductibility of expenses such as guarantee fees or bank fees in computing trading profits for tax purposes. The costs of a share issue, by contrast, are not deductible.

If it is decided to use debt, a further decision must be made as to which company should borrow and how the acquisition should be structured. To minimize the cost of debt there must be sufficient taxable profits against which interest payments can be set.

Normally, the push-down of debt is a structuring measure to allow the offsetting of the funding expenses against target's taxable profits. There are different ways to perform a debt push-down, such as dividend distribution in exchange for debt, or the merger of the acquisition vehicle and the target entity. In the event that the business integration is impossible, other options, such as tax consolidation, might be useful to bring together the profits generated by the target with the interest expense incurred by the acquiring entity.

Typically, a Spanish company is used as the acquisition vehicle, funding the purchase with debt either from a related party (a debt push-down) or directly from a bank. Provided that at least 75 percent of the target's ordinary

share capital is acquired, which, broadly, also entitles the holder to 75-percent economic ownership of the target, group tax consolidation may be claimed. In such case, it should be possible for interest paid to be offset against Spanish taxable profits arising in the target group over the same period. If interest cannot be offset immediately (because there are insufficient taxable profits), the resulting losses can be carried forward and set against future profits of the Spanish borrower.

Both joint stock companies (SAs) and limited liability companies (SLs) are barred from providing finance, fund assistance, or guarantees for the acquisition of their own shares/participation or the shares/participation of their parent company. This restriction does not apply to companies lending in the ordinary course of their business, or to loans made to employees.

Deductibility of Interest

In addition to transfer pricing rules generally, there are other limits on the deduction of interest expenses on debt used to finance an acquisition.

Under Spanish law, when the direct or indirect net indebtedness of an entity with related, non-resident companies exceeds a ratio of three to the net equity (excluding the profit/loss of the year), the interest resulting from the excess will be classified as dividends and will, therefore, be non-tax deductible for the Spanish company.

From 1 January 2004 onwards, thin-capitalization rules do not apply if the non-resident entity is resident in an EU Member State (excluding tax havens).

Additionally, there are a number of situations in which a tax deduction for interest payments can be denied under increasingly complex anti-avoidance legislation. In particular, Spanish transfer pricing legislation can restrict interest deductibility when the level of funding exceeds that which the company could have borrowed from an unrelated third party, or where the interest rate charged is higher than an arm's length rate.

Transactions caught by the rules are required to meet the arm's length standard. Thus, payments of interest to an overseas (or Spanish) parent or overseas (or Spanish) affiliated company that represent an amount that would not have been payable in the absence of the relationship will, under the transfer pricing provisions, not be deductible for Spanish tax purposes. Where both of the parties to the transaction are subject to Spanish tax, the authorities, according to the literal wording of the law, can adjust the results of the party whose benefits have been increased, so that there is usually no impact on

the cash tax payable by the group (although in certain situations losses can become trapped).

The tax authorities could also reject the tax deductibility of interest expenses under the anti-avoidance clauses in the General Tax Law.

Withholding Tax on Debt and Methods to Reduce or Eliminate

The payment of interest and dividends by Spanish residents is, as a general rule, subject to 19-percent WHT, which may be credited against the recipient company's income tax liability. The WHT on dividends is eliminated if the acquiring company holds a participation of more than 10 percent during an uninterrupted period of more than one year after the date of acquisition.

Revenues received in Spain by non-resident entities without permanent establishments are subject to Spanish taxation at the general rate of 24 percent (19 percent for interest and dividends). However, this tax may be reduced or eliminated for dividends, interest and royalties, if the beneficiary is a resident of a tax-treaty country. Additionally, please note that dividends and interest paid to EU residents could be exempt from WHT in certain cases according to Spanish domestic legislation.

Checklist for Debt Funding

- The use of bank debt may avoid thin-capitalization and transfer pricing problems, and should obviate the requirement to withhold tax from interest payments.
- Interest can be offset against taxable income of other entities within the tax group. Interest which cannot be offset immediately (leading to net operating losses), can only be carried forward for offset against future profits of the entities within the tax group.
- Consider whether the level of profits would enable tax relief for interest payments to be effective.
- It is possible that a tax deduction may be available at higher rates in other territories.
- WHT of 19 percent will apply on interest payments to non-Spanish and non-EU entities unless lower rates apply under the relevant tax treaty

Equity

It is possible to finance the acquisition with equity and debt. The distribution of dividends from the target to its shareholders as an alternative method of funding the

acquisition is tax-assessable, although the shareholder may be entitled to a total or partial tax credit.

Tax Neutral Regime for Corporate Reorganizations

There is a special regime in the Spanish CIT Law approved by Legislative Royal Decree 4/2004, dated on 5 March Corporate Income Tax for mergers, spin offs, contribution in kind, and exchange of shares, among others.

This special regime is applicable to mergers, spin offs and other inter-company transactions, mainly aimed at achieving the tax neutrality of corporate restructuring operations by deferring the taxation that could arise at that moment to a future moment in which the acquiring company transfers the assets acquired.

This neutral tax regime is applicable provided that the restructuring transaction is supported with valid business reasons other than tax reasons (anti-abuse clause)

Transactions

Merger

Two kinds of merger are possible in Spain:

- Mergers where the companies involved are dissolved (without liquidation) and their assets and liabilities are contributed to a newly incorporated company. The shareholders of the dissolved companies receive shares in the new company in exchange for their shares in the merged companies.
- Mergers where an existing company absorbs one or more companies. The shareholders of the absorbed companies receive new shares from the absorbing company.

Split

Three kinds of splits are possible in Spain:

- A total split occurs when a company separates its net equity into one or more parts and transfers them as a block(s) to one or more entities (which can be either newly created or already in existence) as a consequence of its dissolution without liquidation, for which the transferring company's shareholders receive representative participation in the acquiring companies. This participation should be given to the shareholders in proportion to the shares they held in the split company and, if appropriate, a monetary compensation that cannot

exceed 10 percent of the nominal value of the shares.

- A partial split occurs when a company separates part of its assets that represent an autonomous branch of activity while maintaining, at least, one already existing branch of activity, and transfers it to one or more entities (which can be either newly created or already in existence), receiving in compensation participations in the acquiring entity that should be allocated to its shareholders in proportion to their respective participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.
- A financial split occurs when a company separates part of its assets consisting of the majority shares in other companies and transfers it to a company (either newly created or already in existence), receiving as consideration shares in the acquiring entity that should be allocated to its shareholders in proportion to their respective participations in the transferring entity's share capital. Similarly, the transferring entity reduces its share capital and reserves and, if necessary, the shareholders of the transferring entity also receive a monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

Please note that when there are two or more acquiring entities in a split, the allocation of the shares of the acquiring entities to the shareholders of the transferring company in a different proportion to that which they held in the transferring company, would require each set of separated assets to constitute an autonomous branch of activity.

Contribution In-Kind

Through a contribution in-kind, a company, without being dissolved, transfers an autonomous economic unit of activity to another entity, receiving in exchange shares issued by the acquiring company. The contribution may also consist of individual assets, provided certain requirements are met.

Exchange of Shares

In an exchange of shares, an entity acquires a participation in the share capital of another entity that allows it to obtain the majority of voting rights. In exchange, the shareholders of the company acquired

are given participation in the acquiring company and, if necessary, monetary compensation that cannot exceed 10 percent of the nominal value of the shares.

Tax Treatment

Transferring Entity

As a general rule, the capital gains derived from the difference between the net book value and the market value of the goods and rights transferred as a consequence of the above transactions would not be included in the taxable base of the transferor's corporate income tax (CIT).

Acquiring Entity

The goods and rights acquired by an entity as a consequence of any of the transactions mentioned earlier would be valued for tax purposes at the same value they had in the transferring entity before the transaction took place. The payment of taxes is deferred until the acquirer subsequently transfers the assets involved in the transactions.

Partners

The income derived from the allocation of the acquiring entity's participations to the transferor's partners will not be added to their taxable bases in certain situations as set out in the legislation. The participations received will have the same value, for tax purposes, as those delivered.

Step-Up and Goodwill Depreciation

In the case of a merger involving Spanish entities, when the absorbing entity holds at least 5 percent of the absorbed entity's share capital, the difference between the acquisition price of the shares held in the absorbed company and their net-asset value (net equity of the absorbed company corresponding to the shares owned by the absorbing company) will be assigned to the goods and rights transferred to the absorbing company as a consequence of the merger in accordance with accounting merger valuation rules. In such a case, the revalued assets would be depreciated for tax purposes according to the new value assigned. Please note that Spanish tax authorities have considered a non-distributable legal reserve should be booked by the company for an amount at least equal to the goodwill tax depreciation.

Any remaining difference not assigned in accordance with these rules (that is, goodwill) will be tax deductible if certain conditions are met (basically, if the seller of the company now absorbed was subject to taxation), up to a maximum of 5 percent per year.

The Spanish Tax Directorate has considered that the non-distributable nature of the reserve (mentioned in goodwill impairment rules section) should also apply to goodwill arising on mergers under the tax-neutral regime.

Indirect Taxation

All the transactions mentioned above, except contributions in-kind consisting of individual assets, are exempt /non subject from transfer tax, value-added tax (VAT) and the local tax on urban land appreciation.

Subrogation in Tax Rights and Obligations

In the above transactions, all of the transferring entity's tax rights and liabilities will be transferred to the acquiring company or, in the case of a partial transfer, only those referring to the goods and rights transferred. In the event that of some of the transactions are covered by the special tax regime, and subject to certain limits, the acquiring company will be able to offset losses from the transferring entity.

Hybrids

Consideration should also be given to using hybrids – instruments treated as equity for accounting purposes in the hands of one party and debt (giving rise to tax-deductible interest) in the other. Various hybrid instruments and structures have been devised to achieve an interest deduction for the borrower with no income pick-up for the non-resident lender. Some hybrid structures are tax-effective, but the situation is changing constantly and specialist advice should be obtained if such financing techniques are contemplated.

Deferred Settlement

In the case of deferred settlement or payment by installments, income, and/or gains shall be deemed to have been obtained on a proportional basis as the payments are made, unless the entity decides to use the accrual method of accounting.

Transactions in which the consideration is received, in whole or in part, in a series of payments or a single late payment will be deemed to be installment or deferred price transactions, provided that the period between delivery and the maturity of the last or only installment exceeds one year.

Notwithstanding the above, when an acquisition involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the business' post-acquisition performance, the Spanish Tax Directorate considers the earlier-mentioned rule inapplicable and the capital gain

obtained will be taxed on an accrual basis (accounting criteria).

Other Considerations

Concerns of the Seller

In the event that a purchase of both shares and assets is contemplated, the seller's main concern is the reduction or elimination of the gain derived from the sale. Thus, the following factors should be taken into account:

- At present there is a 15-year tax loss carry-forward limit in Spain. Companies may decide how and when to offset losses during this period. A major change in shareholding (see Tax Losses) and participation in the transferring company by the acquiring company may reduce the loss carry-forward benefit if the target company has been inactive for any length of time.
- The possibility of reinvesting the proceeds obtained from the sale of assets.
- The date of acquisition is crucial (only for real estate when the seller is a legal entity, and for all assets in cases where the seller is an individual, provided certain requirements are met).

Company Law and Accounting

Spanish accounting legislation was adapted to European legislation by Law 16/2007, which was designed to reform commercial accounting rules and harmonize them with EU rules.

The new General Accounting Plan was approved by the Royal Decree 1514/2007. This stipulated new rules for annual accounts required by Law 16/2007.

For accounting purposes a business combination may be categorized as either an acquisition or an intra-group operation.

In essence, a combination is regarded as a merger when it effects a pooling of business interests (where one company's equity is exchanged for equity in another company), or shares in a newly incorporated company are issued to the merging companies' shareholders in exchange for their equity, with both sides receiving little or no consideration in the form of cash or other assets.

The acquisition accounting may give rise to goodwill. The net assets acquired are brought onto the consolidated balance sheet at their fair values, and goodwill arises to the extent that the consideration

exceeds the aggregate of these values. Acquisition accounting principles also apply to purchases of trade and assets.

An important feature of Spanish company law concerns the ability to pay dividends. Distributions of profit may be made only out of a company's distributable reserves. Interim dividends are allowed.

Pursuant to article 213.4 of the Corporation Law, passed by Royal Legislative Decree 1564/1989, it is mandatory to contribute to a non-distributable reserve annually an amount at least equal to the 5 percent of the goodwill recorded in the balance sheet (up to the value of the goodwill's recorded value). If the company earns no profit, or earns insufficient profit to cover the 5 percent of recorded goodwill, distributable reserves must be assigned to this non-distributable reserve to make up the difference.

Additionally, article 213.3 of the Corporation Law requires that dividends should not be paid unless the distributable reserves are at least, equal to the research and development expenses recorded as assets.

Distribution of pre-acquisition retained earnings of the acquired company should be recorded as a reduction in the value of the participation acquired (for both accounting and tax purposes). In certain cases the purchaser could obtain a tax credit to avoid double taxation for the dividend received (bear in mind that the dividends has not been recognized as a profit, but a decrease in value of the participations acquired) .

Finally, a common issue on transaction structuring is the provisions for financial assistance. Broadly, these state that it is illegal for a company to give financial assistance, directly or indirectly, for the purpose of acquiring that company's shares.

Law 3/2009 regulating structural modifications of commercial companies also deals with financial assistance. It stipulates that in the case of a merger between two or more companies, a report by an independent expert on the merger plan will be required when any of the companies has incurred debt during the previous three years to acquire control over or essential assets from another company participating in the merger. The independent expert must pronounce on whether or not financial assistance has been provided.

Group Relief/Consolidation

The grouping together of companies for tax purposes is possible on the condition that the dominant company, which must be a resident entity in Spain or have a

permanent establishment in Spain, directly or indirectly holds at least 75 percent of the stock of all companies of that group at the beginning of the year in which the tax consolidation regime is going to be applied. This participation must be maintained for the entire fiscal year in which the consolidation regime is applied.

Transfer Pricing

The main rule governing transactions between associated parties is that the transactions should be carried out in accordance with the prices that would have been agreed under normal market conditions between independent companies (that is, the arm's length price).

Dual Residency

There are no advantages in Spain for a company with dual residency.

Foreign Investments of a Local Target Company

As a general rule, from an exchange control point of view, foreign investments are unregulated and can be freely made, although they must be declared to the foreign investments registry by filing the relevant forms.

Nevertheless, if the foreign participation in the Spanish company is higher than 50 percent, prior communication with the general directorate of foreign transactions is required when the foreign investor is a resident of a tax haven.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The step up in the assets acquired can be depreciated or amortized for tax purposes. The goodwill and intangibles acquired in an asset deal can also be depreciated for tax purposes.
- No previous liabilities of the company are inherited (except tax liabilities if a business unit is transferred), unless the acquisitions made by one or several persons or entities constitute an ongoing concern.
- Only part of the business may be acquired.
- In the case of a selling company with tax losses, capital gains can be offset against the seller's tax losses, thereby effectively gaining the ability to make immediate use of the losses.
- Not subject to VAT when the object of the transfer is a branch of activity, (see Recent Developments).

- A profitable business can use its acquirer's tax losses.

Disadvantages of Asset Purchases

- A taxable event in the hands of the seller: the capital gain derived from the transfer is subject to CIT unless it arises as a consequence of a merger, split, or contribution in-kind.
- A higher capital outlay is usually involved (unless business debts are also assumed).
- Possible need to renegotiate supply, employment and technology agreements, and change stationery.
- The benefit of any losses incurred by the target company remains with the target company, unless the transfer is made as a consequence of a merger, split, or contribution in-kind.
- Inheritance of tax liabilities when acquiring a business unit.

Advantages of Share Purchases

- Capital gains on sale of shares by a Spanish company might benefit from participation exemption (disposal of non-resident companies) or from the reduced capital gains tax rate of 19 percent for Spanish individuals. Also resident companies could reduce the capital gain on a disposal of resident entities by applying for a tax credit to avoid double taxation
- May benefit from tax losses of target company (with certain limitations).
- Lower capital outlay (purchase net assets only).
- May gain benefit of existing supply or technology contracts.
- Not subject to VAT or transfer tax (unless real estate is involved).

Disadvantages of Share Purchases

- Acquire unrealized tax liability for depreciation recovery on difference between market and tax book value of assets.
- Liable to any claims or previous liabilities of the entity.
- Losses incurred by any company in the acquirer's group in the years prior to the acquisition of the target cannot be offset against profits made by the

target company unless a specific restructuring is performed.

- Less flexibility in funding options (requires debt push-down strategies to offset interest expense with target business profits).
- Transfer tax may apply when the transaction is a means of selling real estate.
- The affiliation privilege may not apply on dividends distributed from existing retained earnings.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies ² (%)		
Algeria	15	5 ³	0/5 ^{4,5}	7/14 ⁶
Argentina	15	10	0/12.5 ^{4,5}	3/5/10/15 ⁷
Armenia ⁸	18	18	0	0/5 ⁹
Australia	15	15	10	10
Austria	15	10	5	5
Azerbaijan ⁸	18	18	0	0/5 ⁹
Belarus ⁸	18	18	0	0/5 ⁹
Belgium	15	0	10	5
Bolivia	15	10	0/15 ⁴	0/15 ⁹
Brazil	15	15	-10/15 ¹⁰	10/15 ¹¹
Bulgaria	15	5	0	0
Canada	15	15	15	0/10 ⁹
Chile	10	5	15	5/10 ¹²
China (People's Rep.)	10	10	10	6/10 ¹²
Colombia	5	0 ¹³	0/10 ¹⁴	10
Croatia	15	0	0/8 ¹⁴	8
Cuba	15	5	10	5
Czech Republic	15	5	0	0/5 ⁹
Denmark	-	-	-	-
Ecuador	15	15	0/5/10 ¹⁵	5/10 ⁹
Egypt	12	9	10	12
El Salvador	12	0	10	10
Estonia	15	5	0/10 ¹⁴	5/10 ¹²
Finland	15	10	10	5
France	15	0	0/10 ⁴	0/5 ⁹
Georgia ⁸	18	18	0	0/5 ⁹
Germany	15	10	10	5
Greece	10	5	0/8 ⁴	6
Hungary	15	5	0	0
Iceland	15	5	5	5
India	15	15	15	10 ¹⁶
Indonesia	15	10	10	10
Iran	10	5 ¹³	0/7.5 ¹⁴	5
Ireland	15	15	0	5/8/10 ¹⁷
Israel	10	10	5/10 ⁵	5/7 ¹⁸
Italy	15	15	0/12 ⁴	4/8 ⁹
Jamaica	10	5	10	10
Japan	15	10	10	10
Kazakhstan ⁸	18	18	0	0/5 ⁹

Country	Dividends		Interest ¹ (%)	Royalties (%)
	Individuals, Companies (%)	Qualifying Companies ² (%)		
Korea (Rep.)	15	10/15 ¹⁹	10	10
Kyrgyzstan ⁸	18	18	0	0/5 ⁹
Latvia	10	5	10	5/10 ¹²
Lithuania	15	5	10	5/10 ¹²
Luxembourg	15	10	10	10
Macedonia	15	5 ³	0/5 ⁵	5
Malaysia	5	0 ²⁰	10	7
Malta	5	0	0	0
Mexico	15	5	0/5/10 ²¹	0/10 ⁹
Moldova ⁸	18	18	0	0/5 ⁹
Morocco	15	10	10	5/10 ⁹
Netherlands	15	5/10 ²²	10	6
New Zealand	15	15	10	10
Norway	15	10	0/10 ⁵	5
Philippines	15	10 ³	0/10/15 ²³	15/20 ²⁴
Poland	15	5	0	0/10 ⁹
Portugal	15	10	15	5
Romania	15	10	10	10
Russia	15	5/10 ²⁵	0/5 ⁵	5
Serbia ³²	10	5	10	5/10
Saudi Arabia	5	0	5	8
Slovak Republic	15	5	0	0/5 ⁹
Slovenia	15	5	0/5 ⁴	5
South Africa	15	5	0/5 ⁵	5
Sweden	15	10	15	10
Switzerland	15	0 ²⁶	0	5
Tajikistan ⁸	18	18	0	0/5 ⁹
Thailand	10	10	0/10/15 ²⁷	5/8/15 ²⁸
Trinidad y Tobago	10	5/0	8	5
Tunisia	15	5	5/10 ⁵	10
Turkey	15	5	10/15 ⁵	10
Turkmenistan ⁸	18	18	0	0/5 ⁹
Ukraine ⁸	18	18	0	0/5 ⁹
United Arab Emirates	15	5 ³	0	0
United Kingdom	15	10	12	10
United States	15	10	0/10 ⁵	5/8/10 ²⁹
Uzbekistan ⁸	18	18	0	0/5 ⁹
Venezuela	10	0	0 ³⁰	5
Vietnam	15	7/10 ³²	10	10

Notes

- Many treaties provide for an exemption for certain types of interest, such as interest paid to the state, local authorities, the central bank, export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
- In general, a company qualifies for the reduced treaty rates if it has a participation of at least 25 percent of the capital of the Spanish company.
- This rate applies if the recipient company holds directly at least 10 percent of the capital or voting power of the Spanish company, as the case may be.
- The lower rate applies to interest paid by public bodies.
- The lower rate applies to interest on qualifying loans (as defined).
- The higher rate applies to copyright royalties, including films, etc.
- The 3-percent rate applies to copyright royalties on (journalistic) news; the 5-percent rate applies to copyright royalties received by the author or his/her heirs in respect of literary, theatrical, musical or artistic work; the 10-percent rate applies to royalties relating to patents, designs or models, computer software, know-how, and technical assistance.
- The treaty concluded between Spain and the former USSR.
- The lower rate applies to copyright royalties, excluding films, etc.
- The domestic rate applies to interest paid by public bodies (under the treaty such interest is taxable only in the source state and there is no reduction). The 10-percent rate applies to interest on loans of at least 10 years granted by financial institutions for the acquisition of capital equipment.
- The lower rate applies to copyright royalties, including films, etc.
- The lower rate applies to royalties for equipment rentals.
- A minimum holding of 20 percent is required.
- The zero rate applies to interest paid to a bank (as defined). In the case of Estonia, the zero rate on such interest applies by virtue of a most-favored-nation clause of the final protocol to the treaty (under the protocol to the treaty between Estonia and the Netherlands, the rate on such interest is reduced to zero).
- The zero rate applies to loans granted for a minimum of five years; the 5-percent rate applies to interest in relation to sales on credit and interest on loans to finance a construction, installation, or assembly project.
- The general treaty rate on royalties is 20 percent. However, by virtue of a most-favored-nation clause (Protocol, Para. 7), the rate is reduced to 10 percent. (Under the treaty between India and Germany, for example, the rate is currently 10 percent.)
- The 5-percent rate applies to artistic copyrights, excluding films, etc.; the 8-percent rate applies to films, etc., any scientific works, and any equipment.
- The lower rate applies to artistic copyrights and equipment rentals.
- The higher rate applies to dividends paid by Spanish investment institutions.
- A minimum holding of 5 percent is required.

21. The zero rate applies to interest paid by public bodies. The other rates under the treaty are 10 percent and 15 percent. However, by virtue of a most-favored-nation clause (Protocol, Para. 4), the rates are as follows: the 5-percent rate applies to interest derived by banks or insurance companies, and on bonds or securities that are regularly and substantially traded on a recognized securities market; the 10-percent rate applies if the beneficial owner is not a person described above and the interest is paid by banks or by a purchaser of machinery and equipment in connection with a sale on credit (rates under the Mexico-U.K. treaty).
22. The 10-percent rate applies if the Netherlands company is not exempt from corporate tax on the dividends received, and owns at least 50 percent of the capital in the Spanish company or at least 25 percent while another Netherlands company also owns at least 25 percent; the 5-percent rate applies if the Netherlands company, in addition to the above-mentioned holding requirement, qualifies in the Netherlands for the participation exemption on the dividends.
23. The zero rate applies to interest paid by public bodies; the 10-percent rate applies to interest on bonds and debentures offered to the general public and interest in relation to sales on credit.
24. The 20-percent rate applies to films, etc.
25. The 5-percent rate applies if the Russian company holds a capital participation of at least EUR 100,000 in the Spanish company and the dividends are exempt in Russia; the 10-percent rate applies if only one of these conditions is met.
26. This rate applies if a 25 percent capital holding has been held for at least two years.
27. The zero rate applies to interest paid in respect of loans granted by qualifying entities; the 10-percent rate applies to interest paid to financial institutions (including insurance companies).
28. The 5-percent rate applies to copyrights, excluding films, etc.; the 8-percent rate applies to royalties on finance leasing of equipment.
29. The 5-percent rate applies to artistic copyrights, excluding films, etc.; the 8-percent rate applies to copyrights on scientific works, films, etc., and to equipment rentals.
30. The rates under the treaty are 0 percent, 4.95 percent, and 10 percent. However, by virtue of a most-favored-nation clause (Protocol, Art. VII), the rate is reduced to 0 percent. (Under the treaty between Spain and Malta, the rate is 0 percent.)
31. The zero rate applies if the company holds a capital participation of 25 percent. If it is of 50 percent the 5 percent rate would apply.
32. The 7-percent rate applies if the recipient company holds directly at least 50 percent of the Spanish company's capital; the 10-percent rate applies if it holds directly at least 25 percent, but less than 50 percent of the capital.

KPMG in Spain

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