# Cross-border PPL in Spain: Some Food for Thought


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Fundraising is no easy feat and needs to be properly structured on account of financial and tax reasons. More often than not shareholders are debt-holders too, funding their venture, whether real estate or not, through a mix of equity and debt. Several factors are behind debt-financing, such as repayment flexibility, interest tax deduction, keeping the equity structure and the balance of power among company's shareholders as it is, or avoiding discussions on enterprise value.

No matter what sector or project is (e.g., Private Equity, Venture Capital, Real Estate, Telecom, asset-structuring, real estate development planning), it all boils down to maximizing the investment. Financially speaking it is key to optimize the tax deduction of interest for payer as well as its taxation for payee.

It is not unusual that interest is linked to borrower's profit/turnover, such as variable interest of Profit Participating Loan (PPL). Spanish PPL-scheme may also provide a kind of a shield against mandatory dissolution / share capital decrease of Spanish borrower; however, over the past years the "especially related-parties rule" has been a hot topic from Spanish insolvency law. Now, after the economic crisis and the new Private Equity Spanish Law (Act 22/2014), PPL schemes might be gaining ground.

## Former taxation of PPL

Prior to the 2015 tax reform interest from PPL used to be Spanish-corporate-tax deductible for borrower provided that it was:

1. Properly booked as expense in the payer's financial statements in the right tax year;
2. Due to a real need of financing and related to the payer's business activity;
3. Duly documented;
4. Valued at arm's length basis in case lender and borrower were related parties;
5. In compliance with the former Thin-Cap. Rules or the most recent Earning-Stripping rules; and
6. Not regarded as non-tax deductible by the tax law (e.g., intra-group indebtedness linked to certain intragroup transactions unless sound business reasons prove otherwise).

## The 2015 Spanish tax reform: re-characterisation of intragroup PPL

Albeit all the requirements aforementioned are met, interest of those PPL agreements signed on/after 20 June 2014 is not corporate tax deductible for Spanish borrower when lender is part of the same corporate group. As recently ruled by the Spanish Tax Authorities any renewals or extensions after said date of those PPL agreements that were signed before that date would not fall under the scope of the new specific limitation but the general one (interest-barrier rule).

The scope is quite wide. Corporate group is defined by reference to different circumstances such as voting rights or control, whether effective or potential. In addition, the Spanish corporate tax law does not provide a specific definition of PPL. Accordingly, any loans, which show characteristics similar to the ones set out by RDL 7/1996 should be captured by this new rule.

In this regard, when it comes to intra-group PPL, the Spanish law re-characterizes (as dividends) interest paid by Spanish corporate taxpayers. Interest would accordingly not be deductible for the payer, who will have to make a positive book-to-tax correction to its corporate taxable base. Aside from other technical interesting topics (e.g., interaction between this re-characterisation and the interest-barrier rules in light of the wording of the law that does not refer to section 15. a), note that the effect is automatic and no gateway clause is allowed.

On the Spanish tax resident payee's side, it is worth mentioning that the amendment to the European Parent-Subsidiary Directive compels member states to refrain from taxing profits at the level of the parent company to the extent that such profits are not deductible by the subsidiary, and vice-versa to tax them if said profits are deductible for the payer; something along the lines of the *one State Taxation* European principle (i.e. income should be taxed once in one European member state) avoiding not only double taxation but also unintended tax benefits (double non-taxation).

In this regard, under the Spanish participation exemption regime the law re-characterizes said PPL interest not just as dividends but *exempted-dividends* for Spanish tax resident companies. From a technical perspective, this nuance is of a paramount importance, particularly for those corporate domestic lenders with no substantial stake in the borrower.

Take for example one company (A) with two fully owned direct Spanish subsidiaries, B and C. Say C loaned B through a PPL. Interest would not be tax deductible for B. If interest were characterized just as dividends it would be taxable for C, triggering an economic double taxation scenario. Yet, since interest is re-characterized as exempted-dividends, C may apply the participation exemption regime sorting said potential double taxation out (by means of a negative book-to-tax correction).

Therefore, in case of domestic funding scenario regardless of the stocks lenders may have in borrower's equity and being the tax rates equal the re-characterisation adds up for both parties (i.e., non deductible expense & exempted income) avoiding therefore an economic double taxation.

In a nutshell, the exemption for the domestic payee on re-characterized PPL interest avoids any potential double taxation outcome. Vice versa, the full taxation (non-exemption) on interest avoids the so-called double non-taxation outcome when interest is deductible for the domestic payer.

## ¿What does this legal change mean for parties involved in cross-border schemes? A two-digit tax leakage

The impact might not be limited to the Spanish borrower only: the non-deduction becomes a two-digit tax leakage, triggering a cash disbursement or the use of existing tax credits at the level of the borrower. It may as well affect other co-investors due to the change in the Spanish borrower's effective tax rate. Thus, it is worth keeping this in mind when negotiating for example the terms of the investment or financing agreement (e.g., Term Sheet, Shareholders Agreement).

On foreign lenders' side the Spanish withholding tax is always at stake. From an international point of view, it is not unusual that countries levy withholding tax in order to somehow financially counterbalance the cross border interest deduction. But when it comes to cross border scenarios the fact that interest is not deductible for Spanish payer should not necessarily mean that it is tax-free in Spain for non-resident payee.

Having said that, in Spain interest-income is sometimes withholding tax-free (e.g., certain EU tax residents, or by virtue of certain tax treaties), or at least subjected to reduced rates.

The re-characterisation does not seem to clash with the non-discrimination principle foreseen in the OECD Model Convention. It applies to Spanish and Non-Spanish tax resident/national payees alike. With that in mind, for the purposes of foreign lenders' taxation in Spain it would be worth knowing whether or not PPL interest is also re-characterized as dividends according to provision 15 of the corporate tax law, or alternatively as *Exempted-dividends* (provision 21 of the same law). Or a *"two-pronged"* re-characterisation, i.e., dividends for borrowers and exempted-dividends for lenders. Needless to say the global effective tax rate may differ.

¿What if the payee is an EU tax resident parent company holding at least 5% stake in borrower? If interest is re-characterized just as dividends and that re-characterisation is also applicable to non-resident lenders, then the European Parent Subsidiary exemption should apply. Therefore, what formerly was interest (exempt in Spain according to the Spanish law) now are dividends also exempted in Spain (yet, this time subject to different requirements).

¿But what if, by contrast, the payee is an EU tax resident company with no equity interest in borrower, or below 5%?

Take the situation of C in the example above (i.e., C loaning B, having no stock in B). Let's compare a domestic and cross border scenario. In case of re-characterisation of PPL interest as dividends, the Spanish corporate tax resident lender would be tax-free (zero-taxed) on interest-income in accordance with the provision 21 of Spanish corporate law. However, if C were resident in an EU country and interest were characterized just as dividends (not as *exempted-*dividends), PPL interest would be taxed in Spain (i.e., what formerly was exempted interest in Spain now are taxable dividends). That might constitute a potential difference based on the payee's residence. Such a conclusion might be against the EU law and ECJ doctrine (e.g., *Denkavit, Test Claimants*) and the recent one issued almost three weeks ago. Arguments like non-discrimination principle or European free movement of capital are at stake.

On non-European side, sometimes is not as straightforward as for example the German-Spanish protocol. Assuming payee meets the beneficial owner test, ¿what if the payee, for example, is tax resident in the US? The 1990 protocol of the treaty still in force characterizes PPL interest as dividends when it is so characterized by the Spanish domestic law. Now that the Spanish law does start doing so, the potential re-characterisation and effects (e.g., different tax rates in certain scenarios) is something to ponder.

¿And what if the treaty had not included a similar clause? ¿What if the treaty definition of dividends is narrower? ¿*Treaty override* vs. *pacta* *sunt servanda*? ¿And what if payee is not entitled to a tax treaty whatsoever?

Lastly, from an economic double taxation perspective, lenders should also pay close attention to the taxation in their home country, as it might be levied without taking into account the re-characterisation in Spain for Spanish corporate payer (i.e., scenarios other than the ones covered by the parent-subsidiary directive as amended in 2014).

## Alternatives: PPL Direct-funding, other Subordinated Loan, or Convertible Debt

In light of the above, investors, family offices, fund managers, they should all think carefully how to tax-structure the funding in order to try and limit/avoid the effects above. Tax-wise, funding the borrower for instance directly by each individual investor might be better than channelling all the debt-proceeds through one corporate-vehicle (e.g., SPV) which would hold a substantial stake in borrower. Or, fundraising through other schemes, such as convertible-debt or through fixed-interest loans. Provided that those schemes and interest comply with the requirements aforementioned and the hybrid-mismatch rule below explained.

## Latest Spanish tax ruling after the 2015 tax reform

The new taxation of PPL variable interest has been recently confirmed by the Spanish tax authorities. The findings of the ruling, although related to a real estate investment in Spain, are valid for other asset-financing. The tax authorities concluded that the restriction on account of the re-characterisation is not applicable when borrower is funded through a PPL granted by an individual. Therefore, in that scenario, variable interest is tax deductible insofar as the general requirements aforementioned are met. The other side of the coin is the financial risk assumed by the individual lender.

## Hybrid-mismatch-rule: Direct "D/NI" schemes between related parties

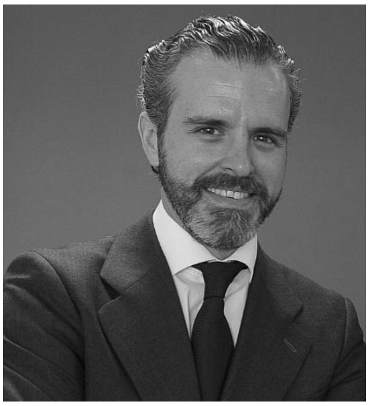
Notwithstanding the above, structuring the PPL directly from (individual) lenders is not always a safe-harbour, particularly, when lender and borrower are related parties. When, for instance, individual lenders also hold substantial shareholding in the Spanish borrower (at least, 25%), or are members of borrower's board of directors, it is worth checking something else in order to secure interest tax deduction for the Spanish borrower: the way payments are taxed in lender's home country. Many times, it is not just a matter of tax-rate differentials. It is a matter of a different characterization of the same arrangement (i.e., equity in one country, debt in another) as per domestic laws. But in this case this non-deduction outcome in Spain is not due to a technical tax re-characterisation. This legal reaction (*linking rule*) stems directly from the international Base Erosion and Profit Shifting (BEPS) initiative endorsed by the OECD to avoid mismatches as a result of different characterization of a payment under the laws of different jurisdictions. It is aimed at tackling Deduction/ Non-Inclusion schemes. Just 48 hours ago, the BEPS 2015 Final Reports were published by the OECD.

As a result of this *primary* response, except for certain investment vehicles, borrower shall only be entitled to deduct interest in Spain when that interest is not re-characterized as equity for lender's taxation at residence, or if it is so re-characterized when it is subject to a minimum nominal tax rate of 10% whether in the same tax year or not as long as it is in a reasonable period of time (i.e., the time period that might be expected to be agreed between unrelated parties acting at arm's length). Otherwise (i.e., not subject to tax, exempted, nominal tax rate lower than 10%), interest would not be tax deductible in Spain. In that case, those payees covered by a tax treaty might be in the normal course of events in a better position to correct the economic double taxation through article 9 of OECD Model Convention.

There is a lot to consider. And to top it all off, in a while the Spanish Law will likely allow to impose penalties to certain tax planning transactions insofar as they are substantially like those published by the tax authorities (surprisingly, not by a formal law).

Needless to say, now more than ever cross-border PPL structures call for a tailored structuring.

For more information, please contact:

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