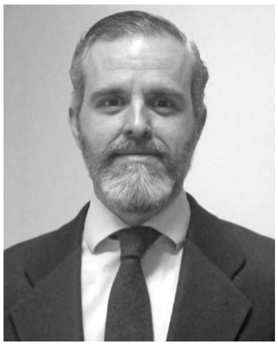

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“LBO & RECAPS” IN SPAIN: A TAINTED TRANSACTION?

What if the net proceeds to be repatriated from Spain were much lower than forecasted? What if your expected tax-free income were finally subject to tax in Spain? What if the tax basis were the gross income?

Investors and Private Equity managers alike should not disregard the recent Spanish Supreme Court resolutions on “LBO & Recap” transactions. From a *sham-doctrine* angle the Court draws the conclusion that the share deal is not a true sale but a hidden dividend distribution. The Court bases their conclusion on factors such as deal value (basically linked to Target’s goodwill) and the unchanged structural elements after the transaction (i.e., test conducted at both Bidco and Target on control, stake and members of Board of Directors). The fact that certain employees bought into the company is negligible considering that the small stock purchased did not mean a real change in the corporate shareholder structure.

In other words, the Court agreed on the tax office’s opinion, i.e., the transaction was basically aimed at anticipating the profits by way of a *simulated* sale. Although formally transferred, based on fact-and-circumstances test the Court confirms there was substantially no real intention to transfer the shares and in doing so the shareholders obtained a tax advantage (e.g., lower taxation than the one applicable to dividends, plus a withholding tax exemption).

From a practical perspective, what does such an approach lead to? Aside from potential penalties, what formerly seemed to be a treaty-tax-free capital gain for foreign investor might then be re-characterised as hidden dividends, which are most of the time subject to a different taxation in Spain. What’s more, if foreign investor were enjoying a tax exemption at residence or profiting from a lower tax rate, this Spanish taxation would become final.

In addition, another interesting question brought up was the interest deduction issue of money borrowed to fund dividend distribution considering there is no specific restriction according to the Spanish tax law.

Overall, although the reasoning of the resolution might be technically questionable (e.g., tax sham vs. tax avoidance), the final outcome is similar to what internationally is being proposed in this day and age, i.e., the latest OECD's (re)action to counteract certain transactions misusing treaty benefits such as certain *dividend-stripping strategies* aimed at turning dividends into exempted capital gains.

Investors across the board should keep this in mind. They may end up in such a situation as a result of the frequently used drag-along clauses.

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