

# Client Alert

Latham & Watkins  
Tax Department

## Spain's Tax Reform Introduces a New Special Tax Applicable to Dividends and Capital Gains Derived From Foreign Subsidiaries not Qualifying for the Participation Exemption Regime

On July 13, 2012, the Spanish Government approved Royal Decree Law 20/2012 (RDL 20/2012) on measures aimed at assuring budgetary stability and promoting competitiveness. RDL 20/2012 provides for different tax measures which, in some cases, entail an amendment of the dispositions introduced by former Royal Decree Law 12/2012 (RDL 12/2012) and, in other cases, the approval of brand-new tax measures aimed at complementing the regulations set forth in RDL 12/2012.

Among the new tax rules that complement the measures introduced by RDL 12/2012, it should be highlighted the enactment of a new special tax on foreign-source dividends and capital gains derived from foreign subsidiaries, which could be applicable under certain circumstances.

In this regard, RDL 12/2012 established a special tax, at an 8 percent rate, which can be applied at the option of the taxpayer on foreign-source income. This special tax, targeted at enabling the repatriation of dividends or generation of income on the transfer of shares in nonresident entities, which despite meeting some of the requirements established under the participation exemption rules<sup>1</sup>, did not meet the requirement of having been subject to a foreign tax identical or similar to Spanish Corporate Income Tax (CIT). In practice, the majority of foreign subsidiaries that may fall within the scope of this rule will be entities engaged in business activities that are resident either in tax haven jurisdictions or in non-treaty jurisdictions that do not impose taxes as a consequence of "tax holidays" or due to an offshore tax regime.

The applicability of such special tax constitutes an incentive for the repatriation of proceeds. It implies a taxation at a rate (8 percent) that is substantially lower than the ordinary CIT rate (30 percent) that would apply otherwise (although double tax credits may also reduce the effective tax rate on those non-qualifying dividends).

RDL 20/2012, in order to complement the aforementioned incentive, has created a new special tax. It is applicable on foreign-source income that cannot benefit from the participation exemption regime or from the special 8 percent tax. The new tax rate (applied alternatively to the 8 percent tax rate) is 10 percent; and the only requirement that must be met is a minimum 5 percent holding owned uninterruptedly for a period of at least one year.

"The special tax may be applied to the realization of dividends and capital gains accrued up to November 30, 2012, provided that the Spanish entity has owned, directly or indirectly, a minimum 5 percentage shareholding in the capital or equity of the nonresident company, uninterruptedly for a year."

In this sense, the Preamble of RDL 20/2012, declares that the justification for a higher rate than that contemplated in RDL 12/2012 derives from the fact that this new special tax will affect a larger volume of transactions, provided that less conditions are required for its application.

It is important to note that the 10 percent tax rate will be applicable in cases where the minimum 5 percent shareholding and one-year holding period requirements are met, independently of whether the "subject-to-tax" requirement is met or not. This different treatment and consideration between the "subject-to-tax" and the "business revenues" requirements implies that the Spanish Government has given preponderance to the latter requirement over the first. This consideration could be interpreted, for the purposes of the participation exemption regime, to suggest that the subsidiaries revenues nature and the circumstance that they are engaged in business activities are more relevant than the fact that the foreign subsidiaries are located in tax haven jurisdictions or in non-treaty jurisdictions that do not impose taxes.

If the purpose of the Government is to give an incentive to the entities having subsidiaries developing business activities (independently of the territory where the activities are carried out), then, the temporary character of the measure adopted is not totally understandable. Once more, the answer is provided by the Government in the preamble of RDL 20/2012 where it is declared that this tax measures should be incardinated in the context of the measures adopted by the Spanish Government to reinforce the Stability and Growth Program 2012-2013 Update. The Program has been designed to ensure Spain fully complies with its tax obligations within the framework of the "Excessive Deficit" procedure established by the European Union.

In this context, a more detailed explanation of the new special tax approved by RDL 20/2012 appears below. It summarizes which applicability conditions and rules are similar, in general terms, to the features of the special tax approved by RDL 12/2012:

- This special tax regime targeting the repatriation of dividends or generation of income on the transfer of shares in nonresident entities at a 10 percent rate is optional for the taxpayer. Thus, the taxpayer is entitled either to (i) elect the application of the general CIT rules to qualifying income or, alternatively, (ii) not to include that income in the tax base and to apply this special tax to it. The expense registered, for accounting purposes, corresponding to this special tax, will not be tax deductible for CIT purposes.
- The special tax may be applied to the realization of dividends and capital gains accrued up to November 30, 2012, provided that the Spanish entity has owned, directly or indirectly, a minimum 5 percentage shareholding in the capital or equity of the nonresident company, uninterruptedly for a year. In the case of dividends, though, the one-year holding period can be completed after the dividend distribution.
- The special tax will not be applicable, however, to the transfer of securities representing the equity of nonresident entities that own, directly or indirectly, shares in Spanish resident entities or assets located in Spain, where the sum of the market value of both items exceeds 15 percent of the market value of their total assets.
- Furthermore, the special tax is incompatible with the international double taxation credits under provisions 31 and/or 32 of the CIT Act.

- The special tax rate will be 10 percent and the tax base, in each case, will be:
  - In the case of dividends and equivalent, the gross amount. In this regard, any impairment losses relating to the participation held that may derive from the distribution of the income subject to the special tax, will not be deductible for tax purposes.
  - In the case of the transfer of securities representing the equity of nonresident entities, the capital gain obtained. However, the portion of the tax base relating to any potential recapture of previous losses derived from the holding of the transferred participation, which may have been deemed tax deductible during the holding period, will be taxed at the general tax rate applicable to the taxpayer.
- The special tax will be due:
  - In the case of dividends and equivalent, on the date the agreement providing for the distribution is approved by the shareholders' meeting or equivalent body.
  - In the case of the transfer of securities, on the date of that transfer.
- The special tax must be self-assessed and paid 25 calendar days following the due date.

Finally, the summary chart below illustrates the tax rate applicable to the repatriation of dividends or income on the transfer of shares in nonresident entities, depending on the participation exemption requirements met in relation with the foreign subsidiaries:

| Minimum 5% shareholding and minimum 1-year holding period <sup>1</sup> | Subject-to-tax requirement <sup>1</sup> | Business Revenues requirement <sup>1</sup> | Tax Rate  |
|--|---|--|---|
| x  | x                                       | x  | 30% CIT General Tax Rate  |
| ✓  | x                                       | x  | 10% (Additional Provision 17th introduced by Royal Decree Law 20/2012) <sup>2</sup>   |
| ✓  | ✓                                       | x  | 10% (Additional Provision 17th introduced by Royal Decree Law 20/2012) <sup>2</sup>   |
| ✓  | x                                       | ✓  | 8% (Additional Provision 15th introduced by Royal Decree Law 12/2012) <sup>2, 3</sup> |
| ✓  | ✓                                       | ✓  | 0% Participation Exemption Regime   |

**Endnotes**

<sup>1</sup> The participation exemption regime generally depends on the fulfillment of the following requirements:

(i) A minimum 5 percent shareholding and minimum one-year holding period;

(ii) A "subject-to-tax" requirement meaning that the foreign subsidiary should be subject to a corporate-level tax having a nature similar to the Spanish CIT (this requirement is deemed to be met if the foreign subsidiary is resident for tax purposes in a jurisdiction that has a tax treaty in force with Spain providing for an exchange of tax information clause). However, this requirement would be deemed not to be met if the foreign subsidiary is resident for Spanish tax purposes in a tax haven jurisdiction, except in the case the foreign subsidiary is resident within the European Union and the taxpayer proves that its incorporation and activities respond to valid economic reasons and that business activities are carried out from that subsidiary; and

(iii) A "business revenues" requirement, meaning that at least 85 percent of foreign subsidiary's revenues derive from business sources (i.e., revenues that are not deemed to give rise to "passive income" for purposes of the Spanish CFC regime and, in particular, the income items described in Section 21.1.c) 1º of the CIT Act) obtained out of the Spanish territory.

Under the participation exemption rules, requirement (i) must be met when the dividend or gain is accrued for tax purposes. With regards to (ii) and (iii), they must be met in each single year of the holding period to have right to a full exemption, even though certain differences exist between dividends and capital gains. Please note that the provisions of the applicable law are complex and a thorough analysis of them goes beyond the scope of this *Alert*.

<sup>2</sup> Applicable in respect of dividends and capital gains accrued before November 30, 2012.

<sup>3</sup> RDL 12/2012 does not require to meet the "business revenues" test each single year of the holding period. Rather, it looks at the test through all the holding period as if it were a single one.

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