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Commentary

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The Devilish Details of the New Spanish Horizontal Tax Consolidation Regime

What the new horizontal tax consolidation regime may mean for private equity sponsors, multinational groups, financial institutions (and everyone else…)

In June 2014, the European Court of Justice (ECJ) ruled that the Dutch fiscal unity regime rules had breached European Union (EU) law because, *inter alia*, the rules did not allow a fiscal unity between two Dutch "sister" companies held by a common parent company based in the EU/European Economic Area (EEA).[1] As a reaction to such ECJ decisions, several EU countries — including Spain — have amended and extended their tax consolidation regimes in order to prevent challenges to their own rules before the ECJ.

As from fiscal years starting from 1 January 2015, the new Spanish Corporate Income Tax (CIT) Act has enlarged the scope of the tax consolidation regime, and allowed that:

- A Spanish parent company (or permanent establishment) holding an indirect "qualifying shareholding"[2] in lower-tiered Spanish subsidiaries (through intermediate holding companies resident in any country other than Spain) could form a tax group including such indirect Spanish subsidiaries.
- Spanish subsidiaries of a common non-Spanish resident "qualifying parent company"[3] form a "horizontal" tax group that would include all Spanish eligible subsidiaries.[4]

The Spanish Congress went beyond the rulings of the ECJ (which would have required that such measures applied in respect of investment from or through EU/EEA entities), and extended the applicability of the tax consolidation regime to holdings held out of any jurisdiction.[5] On its face, such developments in the Spanish tax consolidation rule (and the new rules' worldwide reach) seem to be good news, right?

Not quite.

Horizontal Tax Consolidation Regime in Practice

While the lawmaker's intention in allowing the formation of the new horizontal tax groups was commendable, the wording of the law creates several pitfalls that may affect multinational groups with Spanish investments, private equity sponsors that may be pursuing new acquisitions in Spain, and financial institutions that had financed past acquisitions of Spanish companies (or which could finance new acquisitions).

The overreaching nature of these rules (and their practical implications) might be best explained through the following set of examples:

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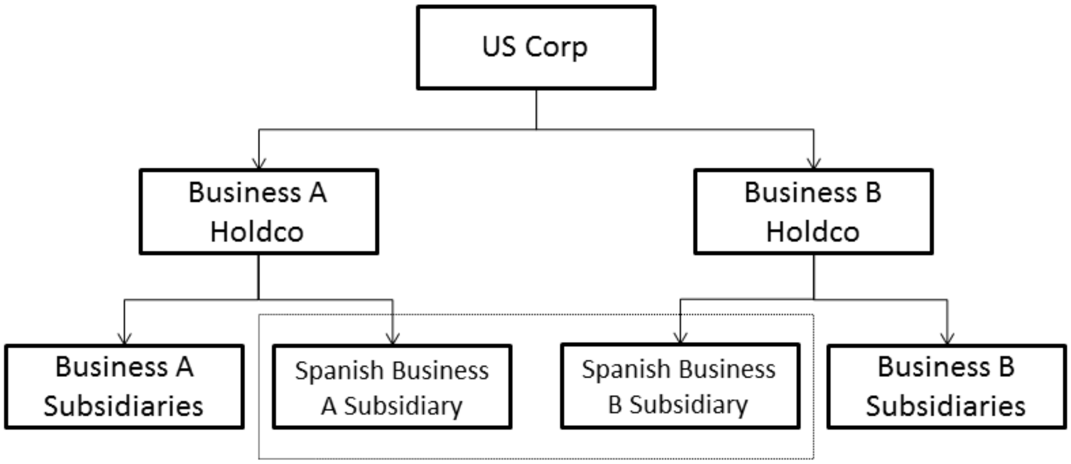
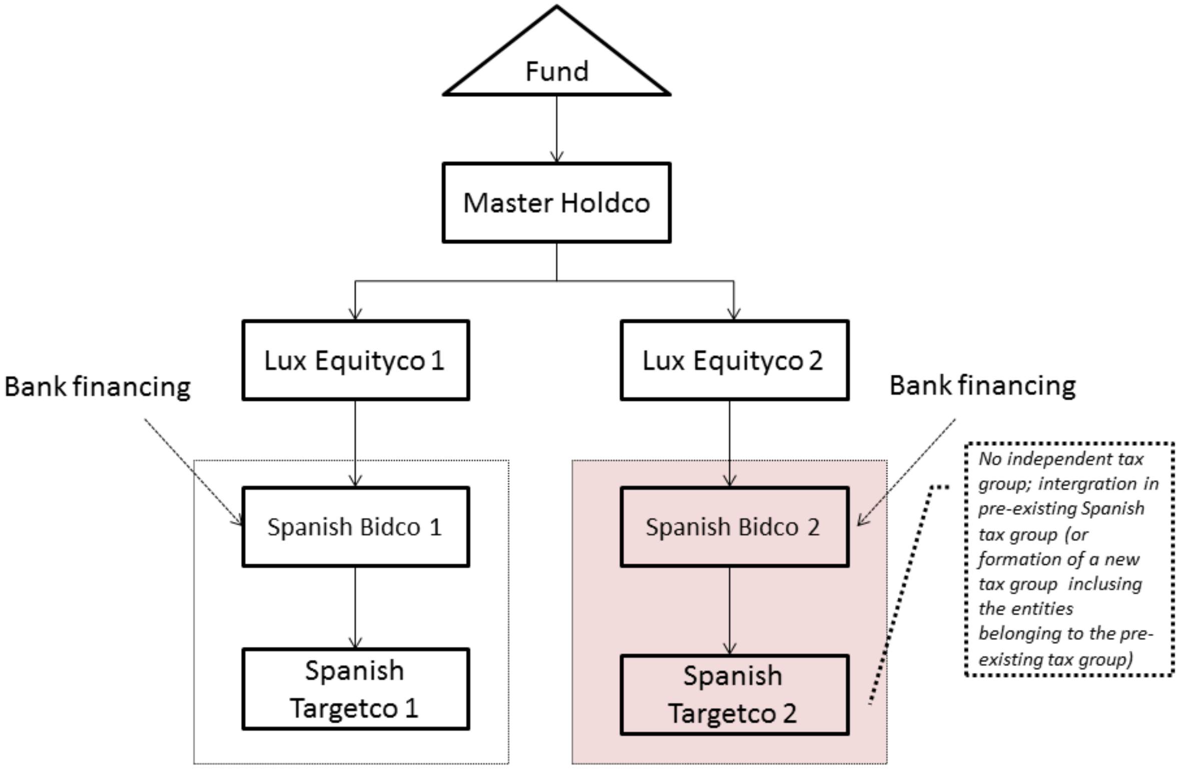
Example #1. A US multinational group of companies (having a US corporation as the ultimate parent company of the group) holds investments in several types of business, which are divided in subgroups from an organization standpoint. The group's legal structure is in line with the internal division of the organization: for instance, business "A" (and all the entities engaged in business A in various jurisdictions, including Spain) is held by a holding entity based in the EU, and business "B" (and all the entities engaged in business B in various jurisdictions, including Spain) is held by a different holding entity based in the EU.. The Spanish subsidiaries belonging to subgroup A have no relationship, from a business perspective, with the Spanish entities belonging to subgroup B. Let's assume that the Spanish entities of subgroup A have their own Spanish tax group in place and the Spanish entities of subgroup B also have an independent tax group.



Horizontal Spanish tax group

Under the new horizontal group rules, the ultimate US parent company (assuming it meets the requirements to be a qualifying parent company) could be deemed to be the parent company of a sole fiscal unity that should be formed by **all** the Spanish entities belonging to subgroup A and B. As per the provisions of the Spanish CIT Act (which have already been interpreted by the Spanish tax authorities in a binding tax ruling recently issued[6]), such entities should be treated as belonging to the **same horizontal tax group** — meaning that one of the pre-existing tax groups should **cease to exist**, with the degrouping charges that could derive from such a termination (*i.e.* recapture of certain intragroup gains that were eliminated in the past due to the applicability of the consolidated tax regime). The Spanish law does not determine which tax group should be terminated, though.[7] The integration of both pre-existing groups into a single tax group should be effective as from fiscal year 2016.[8]

Example #2. An international private equity sponsor has a master holding company in an EU jurisdiction, and perform leveraged buyout acquisitions through subholding vehicles set up exclusively for purposes of performing such acquisitions. Such private equity sponsor already has one Spanish portfolio investment that would qualify as a qualifying shareholding of the master holding company. In order to perform such acquisition, the master holding company had set up a Spanish "Bidco" vehicle that was partly financed through loans granted by financial institutions, and which has acquired 100% of the Spanish "Target" company. Bidco and Target form a tax consolidated group. The private equity sponsor intends to perform a second Spanish acquisition using the same kind of structure used for their first investment (and would seek bank financing to perform such deal as well).



No independent tax group; intergration in pre-existing Spanish tax group (or formation of a new tax group inclusing the entities belonging to the pre-existing tax group)

Pre-existing Spanish tax group

As in the previous example, the fact that there is a common qualifying parent company for both the first Bidco and the second Bidco would mean that the entities related to the second acquisition (*i.e.* the second Bidco and the second target group) should form **a single horizontal tax group**, meaning that the Spanish entities related to the first acquisition and the ones related to the second acquisition might not be able to form independent tax groups.

For the private equity sponsor, this is a major inconvenience. The financial models prepared for the first acquisition (which had been prepared taking into account the features of the first portfolio company and the first Bidco's leverage level) may be significantly changed. Several Spanish CIT rules require the fulfillment of requirements at the **tax group** level (for instance, the rules limiting the deductibility of interest), and the enlargement of a tax group may lead to unexpected tax inefficiencies (and to a greater tax compliance burden).

Furthermore, the existence of an enlarged horizontal tax group is troublesome from the perspective of the financial institutions (both those that have financed the first acquisition and those willing to finance the second acquisition). Each entity belonging to a tax group is jointly and severally liable for the CIT debts of the group it belongs to, and should also have accounts payable and receivable vis-à-vis other group entities (depending on whether each entity benefits from tax attributes of the other group entities, or vice versa). This means that the financial institutions that have financed the first acquisition might be exposed to tax risks associated with sister groups acquired afterwards by vehicles that do not fall within the finance group (as defined for purposes of the first acquisition), due to the mandatory inclusion of such groups in the same horizontal tax group. The same reasoning applies to the financial institutions financing the second (and forthcoming) acquisitions.

Conclusion

In summary, the current framework of the horizontal tax group rules means trouble for a wide array of enterprises and financial institutions. There may be strategies to structure investments in order to avoid the adverse implications of such new regime — although implementing effective strategies requires careful tax structuring on a case-by-case basis. In addition, from the perspective of financing institutions, there are contractual mechanisms aimed at protecting the lenders against horizontal tax group exposures.

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Endnotes

[1] Cases C-40/13, and joint cases C-39/13 and 41/13.

[2] A "qualifying shareholding" would mean a direct or indirect participation in a Spanish subsidiary representing: i) at least 75% of the share capital (70% if such subsidiary has its stock listed in a regulated stock exchange); **and** ii) the majority of the voting rights.

[3] A "qualifying parent company" would be a non-Spanish resident entity that is not resident in a tax haven jurisdiction, has legal personality and is subject to (and not exempt from) a corporate income tax deemed to be similar to the Spanish CIT.

[4] *i.e.* Spanish-resident direct or indirect subsidiaries in respect of which the qualifying parent company had a qualifying shareholding.

[5] Except, in the case of the "horizontal" tax group rule, for parent companies that are resident in a tax haven jurisdiction.

[6] Temporary provision 25, subsection 2. This provision has been interpreted by the Spanish tax authorities in Binding Tax Ruling V2037-15 (dated 30 June 2015). The case described in the mentioned ruling was the case of two Spanish consolidated tax groups that had a common parent company resident in Luxembourg. As per the Spanish tax authorities, as from fiscal year 2015 both groups should be combined into a single tax group (as the qualifying parent company of both groups was the same Luxembourg entity).

[7] See Binding Tax Ruling V2037-15. This means the taxpayer may choose to terminate the pre-existing group that could trigger less degrouping costs.

[8] Temporary provision 25, subsection 5, of the Spanish CIT Act.