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New limitation on the deductibility of interest in LBOs

The Preliminary Draft Law on Corporate Income Tax (the Preliminary Draft Law) submitted to the Spanish Government on 20 June 2014, provides an additional limitation on the tax deductibility of financial expenses related to leveraged acquisitions of shares, which in some cases will imply that almost all of them are not tax deductible.

Current regulation vs regulation contained in the Preliminary Draft Law

Under the current regulation, net financial expenses are deductible for Corporate Income Tax purposes up to an amount equivalent to 30 per cent of the operating profit of the tax period (in the case of entities subject to the special tax grouping regime, the 30 per cent limit refers to the tax group as a whole). However, it must be taken into account that €1m of net financial expenses are tax deductible without any limitation in any case.

According to the Preliminary Draft Law, in tax periods beginning on or after 1 January 2016, an additional limitation for the tax deductibility of interest related to leveraged acquisitions of shares will be applicable when, following the acquisition, the acquired entity: (i) is incorporated into the tax consolidation group to which the acquiring entity belongs; or (ii) is merged with the latter. The purpose of this new limitation is to prevent the activity of the acquired entity from supporting acquisition debt expenses, hence the Preliminary Draft Law provides that such expenses will be deductible with the **additional limit of 30 per cent of the operating profit of the acquiring entity itself** (without taking into account the operating profit corresponding to the activity of the acquired entity in the event that it is subsequently incorporated in the tax group of the acquiring entity or merged with it). We understand that, in cases in which the abovementioned additional limit will be applicable, the minimum deduction of €1m will also be applicable.

Transactions most affected by this new limitation: Leveraged Buy-Out (LBOs) Transactions

The transactions most affected by this new limitation will be the so-called Leveraged Buy-Outs (LBOs).

In this type of leveraged acquisition, the acquiring entity has no operating profit (or a very small one) because it is a holding company that does not perform any activity. Therefore, the implementation of the new limit will mean that all the financial expenses related to the acquisition will not be tax deductible, even if the acquiring entity forms a tax group with the acquired entity or both are merged.

How to mitigate the impact of this new limitation

The impact of this new limitation will be mitigated provided that additional activities are located in the acquiring entity in order to increase its operating profit.

On the other hand, it should also be noted that the Preliminary Draft Law (according to its current drafting and without prejudice to possible changes), in order to foster the capitalization of companies, gives taxpayers the right to a further reduction in the taxable income of ten per cent of the increase in its equity under certain conditions. This new reduction would mitigate, to some extent, the higher taxation resulting from the new limitation provided that the financing of the acquisition is properly articulated.

Temporal scope

As noted above, this new limitation will be applicable to tax periods beginning on or after 1 January 2016. However, it must be taken into account that it will not be applicable to restructuring transactions which have

been carried out prior to 20 June 2014, nor to entities that have been incorporated in a tax group in tax periods beginning before that date.

Final note

This new regulation is not final and it is possible that during the parliamentary procedure it will be subject to change. However, we believe it is important to take it into account due to its relevance for the structures currently in place.

Contacts

Eduardo Gracia
Partner and Head of the Tax Department of Ashurst Spain
T: +34 91 364 9854
E: eduardo.gracia@ashurst.com

Javier Hernández Galante
Partner in the Tax Department of Ashurst Spain
T: +34 91 364 9847
E: javierhernandez.galante@ashurst.com

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