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APPLICATION OF THE SPANISH PARTICIPATION EXEMPTION REGIME IN CORPORATE TAX

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Introduction

The participation exemption regime is regulated in articles 21 and 22 of Spanish Corporation Income Tax Law (Ley 27/2014 del Impuesto sobre Sociedades).

These articles regulate the following tax benefits:

- A. Tax exemption of dividends or participations in other companies' profits
- B. Capital gains obtained in the transfer of shares or participation in entities
- C. Income obtained through a permanent establishment located outside Spain

A. Tax exemption of dividends or participations in other companies' profits (1/3)

1. Conditions to be met by the subsidiary paying the dividends or producing the capital gain.

Dividends perceived by a company are tax exempt from corporation income tax if following conditions are met:

- a) the percentage of direct or indirect participation in the subsidiary's share capital or equity is at least 5% or the acquisition value of the participation is higher than 20 million euros.
- b) The participation must be held without interruption during one year prior to profit distribution or must be maintained subsequently for the time necessary to complete said year. Periods of ownership by other group companies are also counted for to meet this requirement.
- c) If the subsidiary obtains dividends or capital gains from other participated entities that represent more than 70 percent of its income, the application of the exemption requires to meet conditions a) and b) also for such participations. This last condition does not apply, if the taxpayer proves that the dividends or capital gains have been integrated into the tax base of the subsidiary and have not profited from any tax exemption.

A. Tax exemption of dividends or participations in other companies' profits (2/3)

1. Conditions to be met by the subsidiary paying the dividends or producing the capital gain.

Dividends perceived by a company are tax exempt from corporation income tax if following conditions are met:

- d) If the subsidiary is not resident in Spain, its profit must have been subject and not exempt to corporation tax at a rate of at least 10% percent in the year in which the dividends or capital gains distributed were obtained. This requirement is considered fulfilled, if the subsidiary is resident in a country that has signed a double taxation agreement with Spain, that contains an information exchange clause. This condition is not met, if the subsidiary is resident in a country or territory classified as a tax haven, unless it resides in a member state of the European Union and the taxpayer proves that its incorporation responds to valid economic reasons and that it conducts real economic activities.
- e) The exemption is not applied to the part of dividends or capital gains whose distribution generates a tax-deductible expense in the subsidiary.
- f) In the case of distribution of reserves, the last allocations to such reserves will be deemed to have been distributed first.

A. Tax exemption of dividends or participations in other companies' profits (3/3)

2. Other applicable rules to dividend's exemption

- a) Any payments derived from securities representing capital or equity of the subsidiary are considered as dividends, regardless of their accounting treatment.
- b) Remuneration paid for participatory loans granted to entities that are part of the same group of companies are also considered as dividends, unless they generate a tax-deductible expense in the paying entity.
- c) The tax exemption is not applicable to dividends perceived whose amount must be delivered to another entity, producing an expense in the recipient company.

B. Capital gains obtained in the transfer of shares or participation in entities (1/4)

1. Conditions to be met by the subsidiary paying the dividends or producing the capital gain.

Capital gains obtained from the transfer of the participation in a subsidiary are exempt, if the requirements established for dividends exemption are met.

Tax exemption is also applied to capital gains produced by the following transactions:

- a) liquidation of the subsidiary
- b) separation of a shareholder
- c) Merger
- d) total or partial split
- e) capital reduction
- f) contribution of shares
- g) transfer of assets and liabilities.

The requirement of percentage of direct or indirect participation must be fulfilled the day of transfer of the subsidiary.

B. Capital gains obtained in the transfer of shares or participation in entities (2/4)

1. Conditions to be met by the subsidiary paying the dividends or producing the capital gain.

The requirement of taxation of the subsidiary by corporation income tax of at least 10% must be fulfilled in every year of holding the participation. If such requirement is not fulfilled in any of the holding years, the exemption shall be applied in accordance with the following rules:

- a) That part of the capital gain that corresponds to undistributed profits generated by the subsidiary in those years in which the 10% taxation requirement is met are tax-exempt.
- b) Concerning the rest of the capital gain, it will be considered as generated linearly, unless proven otherwise, during the time of ownership of the participation. The part of such capital gain deemed to be generated in those years in which the 10% taxation requirement is met is also tax-exempt.

The part of capital gain not entitled to exemption shall be integrated in the corporation income tax base, being entitled to double taxation deductions, if applicable.

B. Capital gains obtained in the transfer of shares or participation in entities (3/4)

2. Other applicable rules to capital gain`s exemption

If the participation in the subsidiary had been valued in accordance with the Council Directive 2009/133/EC of 19 October 2009 (Mergers Directive) and the application of said directive would have determined the deferral of taxes on capital gains produced by the contribution of a subsidiary that did not fulfil the requirements of the tax exemption, such tax exemption will not be applied to the deferred taxation on the capital gains.

The capital gain`s exemption is not applied in the following capital gains:

- a) The part of the capital gain produced by transfer of the participation in an entity that is considered a patrimonial entity that does not correspond with an increase in undistributed profits generated by the subsidiary during the holding time of the participation.
- b) The part of the capital gain produced by the transfer of the participation in a Spanish or European group of economic interest, that does not correspond with an increase in undistributed profits generated by the subsidiary during the holding time of the participation.
- c) The part of the capital gain produced by the transfer of the participation in a company deemed as transparent according to article 100 of Spanish Corporation Tax law.

B. Capital gains obtained in the transfer of shares or participation in entities (4/4)

2. Other applicable rules to capital gain`s exemption

Capital losses produced by the transfer of the participation in a subsidiary shall not be included in the corporation income tax base, if both requirements are met:

- percentage of direct or indirect participation of at least 5% or acquisition value of the participation is higher than 20 million euros.
- taxation of the subsidiary by corporation income tax of at least 10%.

If the subsidiary is not resident in Spain, capital losses produced by the transfer of the participation in such subsidiary are neither included in the corporation income tax base if the second requirement (taxation of at least 10%) is not met.

Capital losses generated in the event of extinction of the subsidiary will be tax deductible, unless it is the result of a restructuring operation.

C. Income obtained through a permanent establishment located outside Spain

Income obtained through a permanent establishment located outside Spain is tax-exempt if such income has been subject and not exempt to corporation tax at a rate of at least 10%.

Capital gains produced by the transfer of a permanent establishment or by the cessation of its activity are also tax-exempt when the tax requirement is met.

Losses obtained through a permanent establishment and capital losses produced by the transfer of a permanent establishment located outside Spain shall not be deducted from the corporation income tax base.

Losses generated in the event of cessation of a permanent establishment's activity will be tax deductible. In this case, deductible losses shall be reduced by the amount of positive income obtained previously that was entitled to the application of the tax exemption.

A. Tax exemption of dividends or participations in other companies' profits

Example 1: subsidiary pays a dividend to its parent company of 1.000.000 €. The profit of the parent company amounts 3.000.000 including the dividend:

Case 1. The subsidiary is resident in Peru. Peru has not signed a Double Taxation Agreement with Spain, but profits of the subsidiary are subject to corporation tax at a rate of 29,5%. Other conditions of art. 21 Spanish CIT are met.

Profit of the parent company	3.000.000
Exemption of dividend	-1.000.000
Tax base of the parent company	2.000.000
Corporation tax (25%)	500.000

A. Tax exemption of dividends or participations in other companies' profits

Example 1: subsidiary pays a dividend to its parent company of 1.000.000 €. The profit of the parent company amounts 3.000.000 including the dividend:

Case 2. The subsidiary is resident in Bahamas. Bahamas has not signed a Double Taxation Agreement with Spain. Profits of the subsidiary are not subject to corporation tax in Bahamas. Other conditions of art. 21 Spanish CIT are met.

Profit of the parent company	3.000.000
Exemption of dividend	0
Tax base of the parent company	3.000.000
Corporation tax (25%)	750.000

B. Capital gains obtained in the transfer of shares or participation in entities

Example 2: parent company sells a subsidiary resident in Panama. Capital gain on the sale of subsidiary is 2.000.000 €. The profit of the parent company amounts 2.500.000 € including the capital gain.

Case: Panama signed a DTA with Spain on 7th October 2010 and is not considered any more tax heaven since 2011. Profits accumulated by the subsidiary until 31st December 2010 amount 800.000 €.

Profit of the parent company		2.500.000
Exemption of capital gain		-1.200.000
total capital gain	2.000.000	
profits generated before 2011	-800.000	
Tax base of the parent company		1.300.000
Corporation tax (25%)		325.000