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Private Equity: leveraged buy-outs. Significant new changes deriving from the recent Draft Bill on the tax reform.

We provide below some urgent comments in relation to a feature included in the draft bill of the tax reform (the "**Draft Bill**") published by the Spanish Government on 23 June which will affect certain Private Equity transactions. Specifically, it involves several amendments which entail a significant impact on the taxation of leveraged buy-outs ("**LBOs**") of Spanish companies. The Draft Bill contains other measures which could potentially affect sale and purchase operations in general, but those will not be discussed in this Client Briefing.

Key points

- The Draft Bill of the tax reform introduces significant limitations on the tax deductibility of interest deriving from acquisition debt.
- Said limitations will apply to scenarios in which a tax group is created, as well as to mergers taking place subsequent to the buyout.

Background facts

To summarise very briefly, the traditional LBO transaction consisted of using a newly-created Spanish acquisition vehicle (BidCo) that would receive the corresponding acquisition debt prior to acquiring the Spanish company (Target).

The acquisition entailed, in the short or medium term, the execution of a merger transaction, such that there was a debt pushdown to the operating company under the terms generally sought by the financial institutions, together with the application of other tax regimes such as the tax consolidation.

In relation to these transactions, in 2012, an initial amendment was made to the tax legislation which had an impact. It involved a regulation which limited the tax deductibility of interest to 30% of the company's operating profits. As regards consolidated groups, said limitation refers to the group's figures, i.e. the group's EBITDA and interest expenses. Therefore, in an operation such as the one mentioned above, the tax group comprised of BidCo and Target can deduct financial expenses of up to a limit of 30% of the group's EBITDA (in general, this would be Target's EBITDA).

This is the point in relation to which the Draft Bill of the tax reform published on 23 June is most relevant.

New changes introduced by the Draft Bill

As mentioned above, the Government published a reform of the Spanish Corporate Tax Law which fully affects these types of transactions and which will foreseeably enter into force for tax periods starting as of 1 January 2015.

First of all, a new Article 67.b) has been added, named *Special rules for including companies in the tax group*, which stipulates the following:

" (…) b) Pursuant to the provisions of Article 16 of this Law, the interest expenses deriving from debt allocated for the acquisition of stakes in the capital or equity of any type of company included in the tax consolidation group will be deducted with the additional limit of 30 percent of the operating profit of the acquiring company, without including the operating profits of the acquired company or companies, bearing in mind the corresponding removals or inclusions in accordance with Articles 64 and 65 of this Law. These interest expenses will also be taken into consideration in the limit referred to in section 1 of said Article 16.

The interest expenses referred to in this point will receive the same tax treatment applicable with regard to the net interest expenses mentioned in point a) above (…)"

In short, this article establishes that, in respect of companies that are included in a tax group, as may be the case with Target, the interest of the acquisition debt generated in BidCo will have an additional limit on tax deductibility, which will be 30% of the operating profits of BidCo without bearing in mind Target's profits. Thus, in the event that BidCo has not obtained operating profits, the deduction of the interest on the acquisition debt would not be allowed, even when the company is part of a tax group which has indeed obtained operating profits.

An alternative to achieving the deductibility of said interest, a merger between BidCo and Target could be considered; in fact, this was a step that, in most cases, was included in the transaction calendar.

This notwithstanding, the Draft Bill of reform of the Corporate Income Tax Law also refers to these transactions in Article 16.5, which establishes:

"(…) 5. Pursuant to the provisions of this article, the interest expenses deriving from debt allocated to the acquisition of stakes in the capital or equity of any type of company will be deducted with an additional limit of 30% of the operating profit of the company that carried out said acquisition, without including in said operating profit, the profit corresponding to the activity carried out by any other company that was the object of a restructuring transaction with the former, that does not apply the special tax regime established in Chapter VII of Title VII of this Law. These interest expenses will be also borne in mind in the limitation referred to in section 1 of this article (…)"

As can be inferred from this article, when the entity created as a result of the merger calculates its operating profit in order to determine what amount of its interest expenses can be deducted, it must perform an additional calculation. First, it must distinguish which amount of its interest expenses derive from the acquisition debt and, second, in order to determine what portion of that interest is tax deductible, it must calculate its operating profit without taking into account the profit earned by the entity absorbed, in those cases where said absorption has been done by means of a transaction in which the tax-neutral regime has not been applied.

Again, we reach the conclusion that the operating profit of Target (now in BidCo following the merger) cannot be offset using the interest expenses of the acquisition debt, which would now be in the same company.

Options

The only option implicitly admitted by the Draft Bill would be to carry out a merger, but under the tax-neutral regime, since, in that case, the above-mentioned limit would not apply. However, it is important to note that the application of such tax-neutral regime requires the existence of valid business reasons, other than merely tax reasons. If the Spanish Tax Authorities considered these reasons to not exist in a specific transaction, then, in addition to the inherent effects of not applying said regime, one more would now derive, which would be the non-deductibility of the interest on the acquisition debt.

In this regard, and without wishing to expand on this point, the application of the tax-neutral regime to these types of transactions has been the subject of much controversy in recent years, since the Tax Authorities considered the existence of a convincing business reason to be doubtful. The use, as a business reason, of the improvement of the conditions of the debt, as well as the existence of requirements on the part of the financial institutions which made the merger necessary, have been debatable matters. Considering the text of the Draft Bill, it is likely these issues will be even more controversial yet.

Additional aspects

Lastly, it is important to point out that the Draft Bill contains a Transitional Provision Seventeen, which excludes from the application of the previous regulations, inclusions within a tax group carried out during tax periods beginning prior to 20 June 2014, as well as (non-neutral) mergers carried out prior to that date.

Therefore, in the case of acquisitions in which the formation of a tax group between BidCo and Target took place during a tax period beginning prior to 20 June 2014, the limit on the tax deductibility of interest expenses referring exclusively to the operating profit of BidCo, will not apply. In any event, the limit referring to 30% of the operating profit of the tax group will indeed apply.

Likewise, if the merger took place prior to 20 June 2014, the resulting entity could deduct the interest on the acquisition debt, up to the limit of 30% of the operating profit of the entity resulting from the merger.

Contact

Clifford Chance Madrid

Paseo de la Castellana, 110

28046 – Madrid

Tel.: +34 91 590 75 00

Javier Amantegui

Partner, Head of Private Equity

T: +34 91 590 75 76

E: **javier.amantegui@cliffordchance.com**

Roberto Grau

Counsel, Tax

T: +34 91 590 75 12

E: roberto.grau@cliffordchance.com

Pablo Serrano de Haro

Partner, Head of Tax

T: +34 91 590 94 70

E: pablo.serrano@cliffordchance.com