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Client Alert
Commentary

Latham & Watkins Transactional Tax Practice

February 12, 2014 | Number 1646

Tax Ruling Offers Welcome Clarification on Spanish Regime for Qualifying Bond Offerings

New tax ruling addresses controversial aspects of the Spanish tax regime applicable to qualifying bond offerings.

The Spanish Tax Authorities recently published Binding Tax Ruling V3670-13 (the Ruling), which addressed certain controversial features of the special Spanish tax regime applicable to certain qualifying bond offerings — which is governed by Additional Provision Two of Law 13/1985. The Ruling suggests the Spanish Tax Authorities are taking a market-friendly approach, though additional reforms likely are still required.

Background

The Spanish special tax regime, *inter alia*, does not apply Spanish withholding tax on interest payments made to non-Spanish resident investors, as well as, among others, listed Spanish companies that issue bonds directly or through a special purpose vehicle (SPV) located in Spain or in another European Union Member State[1] (other than a tax haven for Spanish tax purposes[2]).

The applicability of this regime to bond offerings carried out by listed entities (or their Spanish or European Union-based SPVs) that are not financial institutions is subject to certain requirements:

- The bonds must be traded in "organized secondary markets".
- If the offering is made by a subsidiary SPV:
  - (i) Its "exclusive" activity or corporate purpose must be the issuance of securities.
  - (ii) The net proceeds of the offering must be "fully and permanently invested" at the level of the parent listed company or at the level of another entity belonging to its group of companies for accounting consolidation purposes.
  - (iii) The SPV must be wholly-owned (directly or indirectly) by the listed parent company.
- Assuming the bonds are registered in a non-Spanish clearing system acknowledged as such by the laws of Spain or an Organization for Economic Co-operation and Development (OCDE) member state (such as DTC, Euroclear or Clearstream), certain contemporary information must be provided by the Paying Agent on each interest payment date.

The Ruling

The Ruling, dated December 26, 2013, addressed a situation in which a Spanish listed corporation (that was not a financial institution) issued a five-year term, fixed rate convertible bond through an SPV (indirectly owned by the Spanish corporation) incorporated in a different European Union Member State.[3] At the term of the bond, the Noteholders had the option to convert the bonds into the stock of a non-Spanish-listed entity belonging to the same group of companies.[4] The convertible bonds were listed in a non-regulated exchange located in a European Union Member State (not Spain).[5] The proceeds raised by the issuer SPV were lent to the Spanish-listed corporation, and then on-lent to another Spanish group company (which used the funds to refinance its bank debt). Finally, the convertible bonds were guaranteed by a share pledge granted by the issuer SPV over the stock that would be delivered in case all noteholders decided to exchange their bonds into stock of the non-Spanish group entity.[6]

The Ruling addressed whether the above mentioned offering would meet the requirements to qualify for the applicability of the Spanish special tax regime.

First, the Ruling had to address the fact that the convertible bonds were traded in a non-regulated exchange within the European Union; and the question of whether or not that should qualify as a multilateral trading facility (MTF) — given the differentiation between "regulated exchanges" and "multilateral trading facilities" (established by the Markets in Financial Instruments Directive (Directive 2004/39/EC) (the MiFID Directive)).

Additional Provision Two of Law 13/1985 does not clarify how the term of art "organized secondary market" should be interpreted, and neither the Spanish Tax Authorities nor the Spanish courts have issued an opinion in that regard before. While a reasonable basis exists to consider that multilateral trading facilities satisfy the requirements to be considered "organized secondary markets," the Spanish tax authorities possibly could take the different position that only "regulated exchanges" would meet such a requirement.

In the view of many market participants, the term "organized secondary market" could be interpreted in line with the wording of the Spanish Capital Markets Act provisions in force in July 2003 when the Additional Provision Two of Law 13/1985 was amended and the term "organized secondary market" was introduced. At that time, the Capital Markets Act referred to two different kinds of organized markets: the "official markets" and "other organized markets or systems of trading which are not considered as an official market." Once the contents of the MiFID Directive had been transposed to the Spanish Capital Markets Act (through an amendment in December 2007) another possible interpretation arose. The prior definition of "official markets" was replaced by the term "regulated markets" and the term "other organized markets or systems of trading which are not considered as an official market," was replaced with "multilateral trading facilities." This change provided grounds to argue that the term "organized secondary market" should refer to both kinds of exchanges. Similarly, no other tax rules making reference to the trading of bonds as a precondition to benefit from a tax exemption shed any light on this controversy.[7]

While this change led to a certain degree of uncertainty in interpreting the requirement, MTFs have become popular among Spanish issuers because of the practical advantages of certain multilateral trading facilities (such as the Euro MTF, operated under the supervision of the Luxembourg Stock Exchange, or the Irish Global Exchange Market (GEM), operated under the supervision of the Irish Stock Exchange) over the regulated exchanges. For example MTFs enjoy a less stringent regulatory regime due to the fact that such venues are not subject to the European Union Prospectus and Transparency Directives.[8] That said, given the question of the MTFs' qualification as "organized secondary market" for purposes of the Spanish tax regime, the offering memoranda of qualifying bond offerings where the bonds were expected to be traded in an MTF often provided for a "risk factor" warning investors about the existing controversy.

Implications

The Ruling somewhat mitigates this controversy. While the Ruling does not analyze in depth the meaning of “organized secondary market” nor reviews the features of the MTF where the bonds were listed, the Ruling does admit that the Spanish special tax regime applies in respect to the offering at stake. This may be interpreted as meaning that the Spanish Tax Authorities concede that MTFs meet the “trading” requirement set forth under Additional Provision Two of Law 13/1985, and may increase the level of comfort for market participants in respect to tax-qualifying offerings.[9]

The Ruling also provides for other welcome developments. As noted above, Additional Provision Two of Law 13/1985 requires that a subsidiary issuer SPV’s activity or corporate purpose must be limited to the issuance of securities, on an “exclusive” basis. In the offering described in the Ruling, the fulfillment of such requirement was doubtful, since the issuer SPV owned stock of the non-European Union group entity which might be delivered to bondholders at the term of the bonds. Consequently, such issuer SPV could be deemed to be engaged in a holding activity — which could jeopardize the applicability of the special tax regime.

However, the Spanish Tax Authorities took the view that this requirement was not breached. As per the Ruling, the Spanish Tax Authorities requested a report from the General Treasury and Financial Policy Secretary on the subject, and the report concluded that in respect of offerings made by subsidiary issuer SPVs owned by listed companies that are not financial institutions, the requirement of exclusive activity or corporate purpose, should not be required.

While this conclusion is certainly good news, as fulfillment of such requirement was difficult to ascertain in practice, issuers would be wise to interpret the Ruling with caution. While the Ruling appears to allow a more flexible interpretation of such requirements in the context of offerings made by SPVs, there is currently no guarantee that such an interpretation would be similar if the subsidiary issuing notes were an entity carrying on a more substantial business activity.

Finally, the Ruling also clarifies an issue that has been a source of discussions in the past. As noted above, Additional Provision Two of Law 13/1985 also requires that the net proceeds of the offering must be “fully and permanently invested” at the level of the parent listed company or at the level of another group entity. This gave rise to concerns about whether a “loan” could be deemed as a suitable instrument to transfer the offering proceeds from the issuer SPV to the other Group entities (as a loan cannot be deemed to be “permanent”). Regardless, the on-lending of offering proceeds was widely accepted as a suitable way to channel offering proceeds to Group entities — especially given the difficulty of finding another alternative that would allow an issuer SPV to obtain the funds necessary to service interest payments on the bonds, and to eventually repay the principal amount of the bonds at maturity. The fact that the Ruling confirms that an on-lending mechanism is also compliant with the special tax regime should be welcome news for issuers and investors.

Conclusion

The contents of the Ruling indicate that the Spanish Tax Authorities may be willing to follow a market-friendly approach in their interpretation of the Spanish special tax regime applicable to qualifying bond offerings. This approach is in line with the Spanish Government’s intention to allow Spanish enterprises to enter the international bond markets (which have been a more attractive source of financing in comparison with bank financing). However, this goal may only be attained if the scope of such a special tax regime is widened (through a reform of Additional Provision Two of Law 13/1985), so non-listed companies (and subsidiary SPVs of such non-listed companies) can also benefit.

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Endnotes

[1] Please note that the special tax regime described herein applies regardless of whether the issuer vehicle is a Spanish SPV or a EU-based SPV, as there are certain features of the regime and information reporting requirements that will apply regardless of the tax residence of the issuer vehicle, and which will depend on the applicability of the special tax regime.

[2] Currently, Cyprus (pending the entry into force of the double tax treaty signed by Spain and Cyprus) is the only European Union Member State that is still included in the Spanish tax haven "black-list."

[3] As noted earlier, since the special tax regime provides for the same requirements for its applicability regardless of whether the issuer SPV vehicle is Spanish-resident or an EU resident, the contents of the Ruling — even though it describes an offering carried out by a EU-resident SPV — are applicable to offerings made by Spanish-resident issuers as well.

[4] It should be noted that the identification of the Spanish corporation issuing the bonds is not provided in the Ruling, although the features of the offering described therein are similar to the features of two bonds issuances actually made by a Spanish multinational infrastructure group in 2013, through a Luxembourg SPV that has offered bonds convertible into ordinary shares of a Group's Latin American subsidiary, which is listed in a Latin American Stock Exchange.

[5] Assuming that the bonds offering described in the Ruling is the same as that carried out by the Spanish multinational infrastructure group in 2013 (as described in the preceding note), convertible bonds issued by such Luxembourg SPV were admitted to trading in the Open Market (*freiverkehr*) of the Frankfurt Stock Exchange — an unregulated exchange that qualifies as a multilateral trading facility (MTF) within the meaning of Markets in Financial Instruments Directive (Directive 2004/39/EC).

[6] In order to execute such share pledge, the issuer SPV had acquired, through a contribution in-kind, an amount of stock in excess of the stock that would be delivered in case all noteholders decided to exchange their convertible bonds, in order to guarantee additional subscriptions of convertible bonds due to an over-allotment option granted to the banks who were the lead coordinators of the offering.

[7] Pursuant to Section 59 of the Spanish Corporate Income Tax regulations, it must be distinguished, for withholding tax exemption purposes, whether a security is traded on an "official secondary market" in Spain (Section 59.q)) or on an "organized market in an OECD country" (Section 59.s)). In this context, the Spanish Tax Authorities issued a ruling dated July 27, 2004, where they do not refer to the term "organized market," as used in section 59.s) as being equivalent to an "official secondary market" or to a "regulated market." On the other hand, an older ruling (1637-98), issued in the context of a Net Wealth Tax controversy, did assimilate the term "organized market" to official markets within the meaning of the Spanish Capital Markets Act.

[8] Directives 2003/71/EC on the prospectus to be published when securities are offered to the public or admitted to trading and 2004/109/EC on the harmonization of transparency requirements in relation to information about issuers whose securities are admitted to trading on a regulated market, as amended.

[9] In particular, if the venue where the bonds described in the Ruling were listed was the Open Market (*freiverkehr*) of the Frankfurt Stock Exchange, its features notably are similar to the features of the Luxembourg Euro MTF and of the Irish GEM.