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## Correspondents

# *Special Reports*



# Taxation of Private Equity in Spain: New Tax Regime for Foreign Transparent Entities and Partnerships

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New Spanish proposed tax regulations aimed at providing a new framework for taxation of Spanish and foreign transparent entities and partnerships became effective 1 January 2003. This article provides a general overview. The regulations will directly affect private equity structures investing in Spain. Unfortunately, the Spanish Parliament failed to take advantage of the opportunity to clarify the controversy and uncertainty surrounding the tax treatment in Spain of foreign transparent entities. The new regulations not only do not provide much help in solving the uncertainty about the characterization of certain foreign transparent vehicles, such as U.S. partnerships or limited liability companies, but, in certain cases, the regulations may even make the applicable tax treatment analysis more complex.

In cross-border private equity investments, it is especially true that tax analysis is crucial for taxpayers to determine the viability of the investment project considered. In broad terms, that tax analysis will focus on two aspects:

- the existence of rules that allow foreign investors and funds to maintain their original legal status and characteristics in the jurisdiction of the target investments; and
- the existence of tax regimes in the target's country of domicile that allow investors to disinvest without suffering an additional tax burden on the capital gain obtained, or with receiving a mitigation or deferral of that tax burden.

The second of those two aspects exceeds the scope of this article. Suffice it to say for the time being that Spanish tax law provides interesting mechanisms and structures that can provide tax-efficient ways for planning the divestitures of portfolio investments.

This article reviews and analyzes the tax measures recently approved by Spanish Parliament. Those measures (the new rules)[1] are intended to address

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[1] Act 46/2002, 18 December 2002.

taxation issues arising when foreign transparent entities[2] invest in Spain. This article analyzes the practical implications of the new rules in a typical cross-border private equity structure because the new rules establish when the benefits granted under double taxation treaties (treaties) will be applicable and will directly affect the taxation of dividends, interest, and capital gains. Consequently, this article includes a commentary on some of the techniques usually available to optimize the taxation of private equity investments in Spain and their validity under the new rules.

The new rules refer to the terms "entidad en régimen de atribución de rentas,"[3] a concept not easily translated into English. In this article for the sake of clarity, the terms "transparent entity" and "tax transparency"[4] will be used to refer to the Spanish concept "entidad en régimen de atribución de rentas." In that sense, the term "transparent entity" will include any kind of entity, whether or not it has a separate legal personality, whose tax regime determines that tax is not imposed on the entity, but on each partner or investor for its share of the entity's income.[5]

For the first time in Spain, the new rules introduce a specific regime to address the taxation of transparent entities investing, and thereby deriving income, in Spain. The Spanish regime is not structured to address a particular type of income or a particular type of investment or transaction. Instead, the regime looks at the characteristics of a particular entity to determine whether it falls within its scope of application. In that respect, it is interesting how the definition of which foreign entities should be included in the regime has evolved. The draft bill initially proposed that all foreign entities, for which income is not taxed at the entity level but directly at the hands of the partners, should fall within the scope of the regime. However, the wording finally approved refers to foreign entities with a similar or identical legal nature to the Spanish entities traditionally included in the regime. This article examines in detail the implications of the drafting change of the new rules.

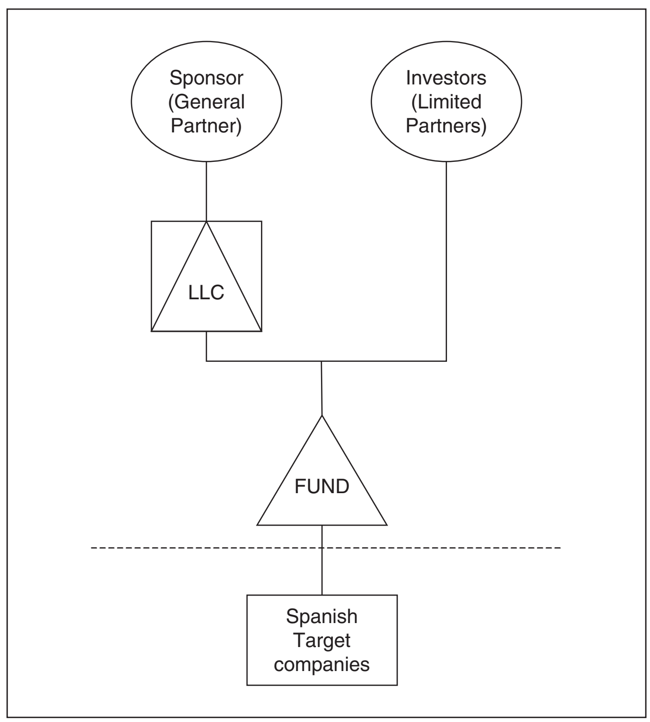
Due to the situations the new rules are designed to address, they will have a decisive effect on private equity structures involving investment funds or other investment vehicles sharing the same element of tax transparency.

## I. Brief Overview of Typical Private Equity Structures: Aims of Investment Tax Planning

Private equity sector investment usually means a basic structure where an investor uses a fund or investment vehicle for the acquisition of portfolio investments,[6] with or without a controlling interest.

In a typical U.S. private equity fund model (see Diagram 1), the structure will operate as follows: A private equity manager (the sponsor) will raise the necessary capital for the investment fund from different investors, possibly from different nationalities and, therefore, with different legal characteristics.

*Diagram 1*




[2]The term "transparent entities" and its exact meaning for the purposes of this article will be explained in subsequent paragraphs.

[3]Under Spanish law, that term reflects the idea that the entity allocates the income it obtains directly to its partners. That income is then taxed in the hands of the partners.

[4]It is important to note that up to now, Spanish tax law has provided for a specific tax regime also termed "tax transparency," which does not apply the same taxation principles as the "tax transparency" concept considered here. In accordance with the provisions of the new rules, that Spanish regime of tax transparency has been abolished as of 1 January 2003.

[5]OECD Report no. 6 on the Application of the OECD Model Tax Convention to Partnerships, paragraph 19, and, in that same sense, vid. article by Carlos Palao Taboada, *Revista Estudios Financieros 209-210*, p. 59.

[6]Because the present article aims to analyze the tax treatment afforded by Spanish tax law to private equity structures investing in Spain, only Spanish target companies will be considered.

In that particular type of structure, the fund vehicle (fund) normally chosen is a U.S. limited partnership (LP), to which the pool of private investors (limited partners) and the sponsor contribute, either directly or through, for example, a limited liability company (LLC) to obtain liability protection. Alternatively, the fund can be directly structured through an LLC. In all those structures, the sponsor typically contributes to a small proportion of the capital of the fund and receives, as an incentive, a special return on its investment, usually a 20 percent interest (the carried interest).

Ultimately, the tax residence and character of the investors determine the tax objectives of the proposed structure. The investment structure, therefore, generally will increase in complexity to accommodate the tax concerns of the diversity of investors involved. In a typical U.S. private equity scenario, one of the main objectives sought by U.S. investors is a fund vehicle that can be fiscally transparent for U.S. tax purposes. That vehicle will avoid U.S. corporate-level income tax at the fund level and, for noncorporate limited partners, obtain flow-through capital gain character for sales proceeds of portfolio investments. That is the case with U.S. partnerships. But investors may choose other vehicles that also can satisfy those "partnership characteristics," for example, a vehicle organized under non-U.S. law eligible for a check-the-box election. Fiscally transparent entities organized under non-U.S. law also avoid application of U.S. antideferral regimes, for example, controlled foreign corporation (CFC) or passive foreign investment company (PFIC) provisions. The income obtained by the fund, therefore, will not be subject to tax at the fund level, but will flow through to the investors and will retain its character and source for the investors' income tax.[7]

The question of whether the vehicle can be fiscally transparent for tax purposes must be examined from three different perspectives:

- the viewpoint of the investors' jurisdictions;
- the viewpoint of the vehicle's own jurisdiction; and
- the viewpoint of the country of residence of the target companies.

To the extent that the tax treatment by the target's state of domicile is inconsistent with the tax treatment granted to the fund under its own jurisdiction, the resulting structure will fail to combine the tax objectives of the different investors. Taxation in the target's country of domicile may result and the structure may not be viable.[8]

> ***Ultimately, the tax residence and character of the investors determine the tax objectives of the proposed structure.***

Moreover, the fund's investment income must receive the relevant treaty benefits so that the investors receive their income distributions in a tax-efficient manner. Treaties, and also certain domestic rules, are crucial to ensure that the fund is not subjected to tax or withholding tax in the target's country of domicile on the income it obtains as dividends, interest, or capital gains from the sale of the underlying investments or shareholdings. However, the need for the fund to be recognized as a transparent entity in the target's country of domicile can complicate and often hinder the possibility of claiming treaty benefits.

If a U.S. private equity fund with EU corporate investors elects Spain as one of its target jurisdictions, the EU investors will normally expect to benefit from the parent-subsidiary directive[9] in the same way as with a direct investment.

Frequently situations may involve leveraged buy-out transactions. In those cases, the structure must allow for the effective deduction of interest payments and avoid situations of financial assistance. Although those issues are beyond the scope of this article, other important questions to consider when structuring the transaction may include pushing leverage down from the fund to the target company, or an intermediate acquisition vehicle or holding company, and offsetting the interest due on those debts against business profits from the target companies. Again, the classification of the fund as a transparent entity becomes especially relevant to claim treaty benefits or domestic law exemptions applicable to interest payments received by the fund.

[7]Certain U.S. limited partners will have divergent interests. For example, U.S. tax-exempts may not like a fiscally transparent structure due to tax exposure on income that is debt-financed, or otherwise is unrelated trade or business income (UBTI). Likewise, non-U.S. investors may not desire to invest through a U.S. partnership. In that context, investments through parallel fund structures may be necessary so that a "blocker" corporation may be interposed between the portfolio investment or acquisition vehicle and the tax-exempt limited partners, or so that foreign limited partners may avoid investing through a U.S. partnership.

[8]*See* Debora L. Smith, Susan Jacobini Harrington, and Jeffrey M. Shaw, "Global Private Equity Investing Balancing Act: Multi-Jurisdictional Groups Face a Variety of Issues in Sructuring Cross-Border Investments," *Taxation of Global Transactions*, Summer 2002.

[9]EEC Directive 90/433/CEE, 23 July 1990.

## II. Spanish Tax Law and Tax Transparency

Until now, no specific provisions in Spanish law covered foreign tax transparent investors or addressed the particular issues raised by private equity structures involving foreign investment funds. The tax regime applicable in those cases was the general tax regime applicable to nonresident taxpayers. Inevitably Spanish law's failure to address the specific issues raised by those structures had created uncertainty about the legal classification ultimately applicable to those investors.

### A. The OECD Report

So far, Spanish tax authorities have not adopted a clear position about the OECD recommendations in the report on the Application of the OECD Model Tax Convention to Partnerships (the OECD report). Although, in practice, they had issued rulings that follow some of the recommendations in the OECD report, especially about the application of treaty benefits to investors in nonresident transparent entities.

> ***Until now, no specific provisions in Spanish law covered foreign tax transparent investors or addressed the particular issues raised by private equity structures involving foreign investment funds.***

The OECD report addresses situations where an inconsistent approach in the tax treatment of a partnership can lead to nonapplication of treaty rules. The report is concerned that the states of domicile of the target investment, the fund, and the investors may treat the fund differently. In each of those jurisdictions, the fund can either be disregarded or treated as a separate legal entity. The approach adopted in each case is crucial for satisfying residency criteria or "subject-to-tax" clauses in the relevant treaties.

The OECD report analyzes many different situations and offers different practical solutions. However, one of its main conclusions is that partnership members should be entitled to claim benefits from the treaty between each investor's state of residence and the country of source — Spain, in this case — when the partnership is considered transparent in its own state of residence and cannot, therefore, claim treaty benefits because the relevant treaty does not contain specific provisions to address partnerships.[10]

### B. Standpoint of the Spanish Tax Authorities

The opinions issued by the Spanish tax authorities before the approval of the new rules are in line with that particular OECD recommendation.[11] For instance, a ruling from 5 February 1998 analyzes the application of the U.S.-Spain treaty and, therefore, the tax treatment of a U.S. LP with Japanese partners and investments in Spanish companies. When asked whether the U.S. LP can claim the benefits from the U.S.-Spain treaty, the tax authorities concluded that if the income derived by the LP is allocated directly to its partners, those partners will be entitled to claim the benefits under the relevant treaty between Spain and their state of residence. In that case, each investor must prove that it fulfils the necessary requirements to be eligible for treaty relief. On those facts, the Spanish tax authorities decided that the Japanese investors would be allowed to claim the benefits granted under the Japan-Spain treaty as long as the U.S. LP's Spanish income was not taxed in the hands of the LP, but was directly allocated to each of its Japanese investors.

The tax authorities also have analyzed the tax regime applicable to U.S. LLCs, but those were situations where Spanish investors used that particular type of vehicle to invest outside Spain. Therefore, the conclusions from those rulings are not completely applicable to structures where the LLC is the vehicle through which investments are made in Spain.

Rulings from 1 March and 30 October 2001 consider the possibility of a Spanish holding company applying Spanish corporate tax exemptions to income derived from nonresident subsidiary companies, when a U.S. LLC is placed between the Spanish holding company and the nonresident subsidiaries. Those rulings give special attention to the issue of whether an LLC, as a transparent entity for U.S. tax purposes, fulfils the requirements of the Spanish participation exemption regime and, in particular, the requirement that the company paying the tax-exempt income be subjected to taxation of a similar nature to the Spanish corporate tax. The Spanish tax authorities concluded in both cases that the Spanish holding company may apply the participation exemption on the income derived from the LLC. It reached that conclusion because the U.S. tax treatment of the LLC is similar to the tax treatment afforded in Spain to transparent entities, or "entidades en régimen de atribución de rentas," where income is taxed directly in the hands of the entities' partners.

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[10]Paragraph 35, OECD Report on the Application of the OECD Model Tax Convention to Partnerships.

[11]The same position was adopted in rulings issued before the adoption of the OECD Report, for example, 30-7-1993 with regard to U.S. and U.K. partnerships, and 11-3-1994 with regard to U.S. partnerships.

So far, and considering that no specific legislation covering nonresident transparent entities existed, the Spanish tax authorities generally have allowed those entities to be disregarded for Spanish tax purposes. The transparent characteristics granted to them in their own jurisdiction prevailed in determining their taxation in Spain.

In the case of investment funds treated as transparent entities in their home countries, that interpretation would allow for the application of the treaty between each investor's state of residence and Spain.

Apart from the ruling mentioned above regarding LLCs, the analysis of the tax transparency of vehicles used by Spanish investors has not merited special attention from the tax authorities so far. The new rules are the Spanish Parliament's first attempt to specifically address the controversial questions around Spanish investors using nonresident transparent vehicles. For instance, the new rules now provide for rules to determine the legal classification of the income obtained by Spanish entities through partnerships or other entities with no separate legal status.

## III. Basic Principles in Nonresident Taxation Under Spanish Law

A clear explanation of the new rules requires, as a preliminary step, a quick mention of the basic tax mechanisms applicable under Spanish domestic law to nonresident entities.

- **Taxpayers:** Nonresident entities are subjected to Spanish nonresident income tax (NRIT) on income and capital gains obtained, whether or not the income or capital gains can be attributed to a permanent establishment (PE) of the nonresident entity.

  In particular, nonresident entities with no PE in Spain are subject to tax on dividends and interest paid out by Spanish resident companies and on capital gains from the sales of shares in Spanish companies.

- **Dividends:** Dividends paid out by a Spanish company to a nonresident company are subject to NRIT. Therefore, the company distributing the dividend must withhold tax at a 15 percent rate.

  The taxation mechanism of Spanish NRIT makes the nonresident company liable to pay tax, while, at the same time, the Spanish company paying out the income is liable for withholding the tax. When the Spanish company has withheld the corresponding NRIT from the income paid out, the nonresident taxpayer is deemed to have complied with its duties to pay NRIT and file the corresponding return.

  Besides the reduced withholding tax rates under the relevant treaties, Spain's implementation of the EU parent-subsidiary directive provides an exemption from withholding tax to dividends distributed to EU companies. For the exemption to apply, certain requirements must be met. The distribution must derive from a minimum 25 percent holding, which must have been held for a minimum period of one year. There are, however, antiabuse provisions designed to cover cases where parent EU companies are in turn held by non-EU companies.

  The application of the reduced treaty rates or of the EU parent-subsidiary exemption requires that, prior to the distribution date, the company receiving dividends must provide the Spanish company distributing them with a tax residence certificate.

- **Interest:** Interest paid by a Spanish company to a nonresident company is taxed under Spanish NRIT Law. The Spanish company paying out the interest must withhold tax at 15 percent.

  Apart from reduced treaty rates, interest paid to EU lenders is exempt from Spanish NRIT.

- **Capital gains:** Spain taxes capital gains derived by nonresident companies from a transfer of assets located in Spain, especially shares of Spanish companies, at 35 percent. Spain does not levy the capital gains tax through withholding. Instead, the nonresident taxpayer must file the appropriate return and pay the tax directly.

  The majority of treaties provide that capital gains are subject to tax in the contracting state in which the transferor is a resident. However, some treaties contain special rules applicable to transfers of significant holdings (for example, the U.S.-Spain treaty) or of holdings in real estate companies.

  Capital gains obtained by EU companies from transfers of shares of Spanish companies are exempt from NRIT, provided that the holding has not exceeded 25 percent during the previous year.

- **Treaties:** The Spanish tax authorities require tax residence certificates to prove eligibility for treaty benefits, which are valid for one year.

## IV. New Rules Applicable to Transparent Entities

The legislative changes for transparent entities in the new rules have been included both in the Individual Income Tax (IIT) Act and in the NRIT Act. In Spanish law, the "entidades en regimen de atribución de rentas" tax regime has existed traditionally to generally regulate the treatment of Spanish entities with no separate legal identity — such as civil law partnerships with or without legal personality, estates or assets receiving certain kinds of special separate treatment — although not exclusively.

> ***The new rules include both Spanish entities and nonresident entities in the category of tax transparent entities.***

All commercial companies, with or without limited liability, generally were subject to Spanish Corporate Income Tax (CIT), but civil partnerships and estates were neither subject to CIT, nor IIT, because their income was taxed directly at the partners' level. Until now, that tax transparency regime was not expressly applicable to nonresident entities.

The new rules include both Spanish entities and nonresident entities in the category of tax transparent entities.[12] This article explains in more detail later that nonresident transparent entities *with a presence in Spanish territory* are subject to NRIT on the income that can be allocated to their nonresident partners. Therefore, in that specific situation, Spanish law steers away from the transparency principle to favor tax collection at the income's source and may, therefore, create some tension.

**A. Transparent Entity Classification**

*1. Spanish and Nonresident Transparent Entities*

First the distinction between Spanish and nonresident transparent entities must be addressed:

*a. Spanish Transparent Entities*

This article does not study Spanish transparent entities in detail as they are not directly relevant to private equity structures involving foreign investors. That category includes the Spanish entities traditionally considered transparent for tax purposes (for example, civil law partnerships, whether or not they have separate legal personality, estates, or assets receiving certain kinds of special separate treatment). However, legal entities with a commercial purpose are not included in that category. In other words, Spanish entities, such as *Sociedades Comanditarias*, which can more easily be deemed, from a commercial and civil law perspective, to share some common characteristics with U.S. LLCs or LPs are not included in the Spanish transparent entity regime. Instead, they are treated as corporations and are subject to income tax at a corporate level.

The new rules also have introduced important changes to the taxation in Spain of nonresident investors using Spanish transparent vehicles. For the first time, Spanish law expressly establishes how to allocate income to nonresident partners in Spanish transparent entities. The provision contained in the new article 32 of the NRIT Act is especially important because it states that nonresident partners in Spanish transparent entities carrying out "business activities" will be deemed NRIT taxpayers with a PE.[13]

*b. Nonresident Transparent Entities*

The first draft of the new rules defined the nonresident entities covered by the regime as those entities for which the tax laws of the state regulating the entities' functioning allocated the income directly to the partners. Therefore, the wording used traditional tax transparency principles.

However, Spain amended the draft. The amended definition of the foreign entities included entities with or without separate legal identity that are incorporated under the laws of other states that, in their state of residence, are not subject to a tax similar to Spanish CIT. Although different from the first draft, the second wording still used tax transparency principles.

Surprisingly, the bill was amended again, so that the wording finally approved by Spanish Parliament seems to move away from tax transparency principles. It refers to foreign entities with a "similar or identical legal nature to the Spanish entities" traditionally covered by that regime, that is, civil law partnerships with or without legal personality, estates, or assets receiving certain kinds of special separate treatment.

The authors believe that under the first draft of the new rules, it was clear that U.S. LPs, U.S. LLCs which were transparent for U.S. tax purposes, would be treated as flow-through entities for Spanish tax purposes. However, that position is hardly defendable with the wording finally approved.

Only by interpreting the rules very broadly could tax practitioners argue that the new rules cover all entities or investment vehicles, with or without separate legal personality, where income is not taxed at the entity level, but rather at the member level — in

[12]The new rules refer to "Entidades en régimen de atribución de rentas."

[13]Potential tax planning opportunities may be available for U.S. funds that use a Spanish holding company organized as a Spanish civil partnership, but with a U.S. check-the-box election to be regarded as a corporation for U.S. tax purposes: A basis step-up inside the target for U.S. tax purposes may be possible; the use of a same-country holding company would permit avoiding CFC income on dividends and interest from the lower-tier Spanish target to the upper-tier Spanish civil partnership; and, moreover, assuming that carrying out "business activities" for that purpose does not include holding shares of a Spanish company for investment, the U.S. funds in that structure would avoid a PE.

accordance with transparency principles. Those principles would allow inclusion of partnerships and other types of investment vehicles or arrangements without separate legal personality, as well as entities or corporations, with or without limited liability, if the income is taxed in the hands of the partners. The OECD report recommendations would support interpretation of the new rules. That interpretation also would be consistent with the position adopted by the Spanish tax authorities in the rulings mentioned above, which predate the approval of the new rules.

Pending more debate on the provision's scope and following a literal interpretation of the new rules, it may be difficult for Spanish legal advisers to ascertain whether the legal nature of a particular investment vehicle, especially one organized under a jurisdiction with a substantially different legal culture, is identical or similar to a particular Spanish entity.

There can be no doubt that corporations, which are tax transparent in the investors' jurisdiction but nontransparent in their state of residence, are not included in the new rules. That type of corporation would never have fallen within the scope of the new rules, not even under the draft wording, regardless of whether the corporations benefited from tax participation exemptions on their income.

Holding companies in overseas investments are one example of that type of entity. Under certain conditions, they may:

- elect to be considered transparent for U.S. tax purposes, so that the qualification of the income deriving from the underlying assets can be maintained;
- not be subject to tax on the income derived from underlying assets — such as dividends and capital gains — in the state of residence of those corporations.

Those entities are frequently incorporated as limited liability companies in European jurisdictions and should not be included within the scope of the new rules, despite that, in their jurisdiction, for example, the U.S., the partners may elect to treat the entity for domestic U.S. tax purposes as a partnership.

Later this article will discuss many planning techniques for private equity in Spain that include using EU holding corporations that invest in Spanish assets. In the authors' opinion, the new rules will not limit the use of those structures but tax practitioners must pay special attention to which entities the Spanish tax authorities will consider transparent.

*2. Entities With and Without a Spanish Presence*

The new rules distinguish between nonresident transparent entities with a presence in Spanish territory and nonresident transparent entities without that presence.

That difference may prove crucial to private equity investors because, as previously discussed, nonresident transparent entities with a presence in Spanish territory will be liable for tax in Spain at the entity level.

*i. Nonresident Transparent Entities With a Presence in Spanish Territory*

The distinction established in the new rules creates a new type of taxpayer for Spanish NRIT by including transparent entities with certain presence in Spain.

> ***There can be no doubt that corporations, which are tax transparent in the investors' jurisdiction but nontransparent in their state of residence, are not included in the new rules.***

Nonresident Spanish transparent entities with a presence in Spanish territory are classified as real taxpayers for NRIT purposes. Spain has a new taxation mechanism for those entities in Spain: All the income derived by those entities, which can be allocated to their nonresident partners or investors, will be taxed in Spain.

*Definition of "Having a Presence in Spanish Territory"*

The new rules' definition of presence in Spanish territory is in line with the concept of PE contained in domestic law or in the OECD Model Tax Convention. According to the new rules, a business has a presence in Spanish territory if it pursues business activities and carries on all, or part, of those activities on a continuous and recurring basis. It also requires the use of a specific premises or workplace, or an agent empowered to enter into contracts on behalf of the entity who carries on the business activities. Contrary to the definition of PE in domestic law or in the OECD Model, the new rules do not require that the agent habitually exercise authority to conclude contracts.

When considering private equity investments in Spain, the definition of the concept of presence in Spanish territory must refer to entities that carry out business activities. "Business activity" is a set of terms well-known in Spanish tax law. It does not include holding shares, or purchase and sale of shares, if no specific material means or personal resources are used to carry out the activity. Consistent with that principle, Private equity funds with no employees and no material resources that limit their activity to investment in shares of Spanish companies should not fall within that category. Investors should carefully analyze their economic activity to avoid taxation of the investment fund.

*Tax Treatment*

Entities with a Spanish presence will be subject to NRIT as taxpayers and will be required to file an annual tax return. That is a move away from tax transparency principles making the income directly taxable at the entity's level. The mechanisms used to tax those entities are similar to those used to tax nonresident taxpayers with a PE in Spain, although specific provisions apply that are different.

***Private equity funds with no employees and no material resources that limit their activity to investment in shares of Spanish companies should not fall within that category.***

The first of those differences is that the taxable base for the NRIT tax return is the income allocated to the nonresident partners, regardless of where that income is obtained. The authors believe that should be taken to mean only the income that would be considered taxable income under the NRIT Act. Therefore the regime would only cover income, which under NRIT rules, would be deemed to have been obtained in Spain. The part of the income corresponding to partners resident in Spain will not be included in the entity's taxable base, but instead will be taxed directly in the hands of the partners, in accordance with the partner's own taxation regime — IIT or CIT, depending on whether the partner is an individual or an entity.

The tax deemed payable would be 35 percent of the taxable base assessed, according to the principles provided above. Moreover, the entity will be under a duty to make advance part payments of its annual tax due.

Additionally, income paid to those entities will be subject to *withholding tax* under IIT rules, regardless of the tax status of the partners. If nonresident partners are entitled to treaty benefits, Spanish law establishes that the corresponding share of the tax paid by the entity will be treated as having been paid by the nonresident partner. Effectively, the new rules apply tax transparency principles, although only for nonresident partners entitled to claim treaty benefits. The new rules seem to allow those nonresident partners to ask for a refund of any excess tax paid by the entity based on the application of relevant treaty benefits. That would be the case, for example, if the nonresident partners were exempt from tax on the capital gains on the disposition of shares of a Spanish target, should the relevant treaty allocate the right to tax the capital gain only to the contracting state of which the transferor is a resident. The same principle would apply, should the partner benefit from the domestic exemption applicable to EU parent companies.

To summarize, nonresident transparent entities with a Spanish presence that fulfill the above criteria will be liable for tax in the same way as nonresident taxpayers with a PE in Spain. That approach is a clear move away from tax transparency principles. However, Spanish law seems to allow partners in those entities that are eligible for treaty benefits to claim back any excess tax paid by the entity on the basis of the treaty benefits.

*ii. Nonresident Transparent Entities With No Presence in Spanish Territory*

*Tax Treatment*

Those entities will not be subject to entity-level tax. Instead, the income will be allocated to their partners under Spanish tax law. Spanish resident partners will include their share of the income in their return for direct taxes (IIT or CIT), whereas nonresident partners will be subject to NRIT, as if the entity had not existed.

As NRIT taxpayers, nonresident partners will be liable for NRIT on the income allocated to them through the transparent entity. That precise mechanism allows the partners to claim exemptions or reduced tax rates provided by Spanish domestic law or treaty provisions. However, the partners must prove their entitlement to those benefits by obtaining a tax residence certificate. That approach allows the recognition of the entities' tax transparent nature and permits the application of the treaty signed with the partners' state of residence, while disregarding the entity for Spanish tax purposes.

A direct consequence of the Spanish taxation system for nonresident taxpayers previously discussed is that the withholding procedure can become exceedingly complex. That is because Spanish tax law imposes two separate duties — on the company paying the earnings (interest payments or dividend income, but not capital gains) to withhold tax, and on the nonresident taxpayer to pay tax.

In contrast to the treatment afforded to nonresident transparent entities having a presence in Spanish territory, there is no general rule whereby earnings paid to nonresident transparent entities with no presence on Spanish territory are subject to *withholding tax*.

The withholding procedure instead requires that, as a first step, the nonresident transparent entity must prove to the Spanish company paying out the income: (i) which is the state of residence of the entity's nonresident partners; and (ii) which share of income must be allocated to each of those partners. There is, therefore, a duty to prove entitlement to claim treaty benefits and reduced tax rates through ordinary procedures, that is, certificate of tax residence acceptable to the tax authorities.

The Spanish company paying out the income must withhold tax on account of the nonresident partner, not on account of the nonresident entity, in accordance with the facts of each case. There will be no duty to withhold, if the taxpayer proves exemption under a treaty or under the parent-subsidiary directive.

Should the nonresident transparent entity not be able to prove the tax residence of its partners and their share in the entity's income, the Spanish company must withhold tax at the standard statutory rate. In that case, the residence or circumstances of the entity's partners will be ignored. Capital gains are not subject to the withholding procedure,[14] and in those cases the partners will be directly liable to pay tax and file the appropriate tax return, just as if the entity had not existed.

If the transparent entity is incorporated under the laws of a territory classified under Spanish law as a tax haven, that entity would be subject to withholding tax in all cases at the domestic rate.

Spanish law does not address the question of the tax transparency levels that should be analyzed — a point that can prove to be important because partners of private equity funds also can be funds or other transparent vehicles. In that context, the new rules simply refer to nonresident transparent entities and their partners. However, the new rules seem to allow for the proof of the tax residence to be referred to the ultimate partners of the transparent vehicles. The rules consider those partners the NRIT payers and eventually afford them the relevant exemptions, or tax rate reductions under the relevant treaties or under Spanish law.

*Treaties With Partnership Provisions*

The new rules can cause controversy in the interpretation of treaties with partnership provisions, such as the U.S.-Spain treaty. According to those provisions, the partnership is considered resident within the meaning of the treaty, as long as its partners are subject to tax in the partnership's state of residence. That principle would be in direct conflict with the new rules, if the U.S. partnership were disregarded for Spanish tax purposes. In practice, the same result could be reached if the members of the partnership could prove that they were tax residents of the United States and could claim benefits under the U.S.-Spain treaty.

In cases involving treaties without partnership provisions, the new rules allow the partners to apply the treaty between each investor's state of residence and Spain, provided that the nonresident transparent entity has complied with the proof requirements above.

The Spanish tax authorities were applying that same principle in the rulings mentioned above, although that approach was not based on any express legal provision. Spain therefore is coming close to the recommendations contained in the OECD report. Spanish law is taking a definite step away from the approaches adopted by other states, where treaty benefits are not allowed to the entity, nor to its partners, unless the treaty expressly contains partnership provisions.

***Newly approved legal provisions state that the legal nature, not the tax treatment, of the investment vehicle is the key factor in determining whether Spain will treat those vehicles as transparent.***

With the new rules, however, the Spanish Parliament has missed an opportunity to give the appropriate legal backing to the tax authorities' rulings mentioned above. Therefore, although the taxation system to which the nonresident entities are subject rests on transparency principles, the definition of which nonresident entities will or will not be included within the provisions of the new rules does not resort to transparency principles. Instead, it requires a complex analysis of the legal nature of the nonresident entity considered, in clear contrast to the OECD recommendations.

*Classification of U.S. LLCs/LPs*

In the investment structure presented in the second section of the this article, the possibility of using a U.S. LP or a U.S. LLC was considered because those entities are not subject to tax at the entity's level, but rather at the level of the partners.

Given their limited liability characteristics, tax treatment, and frequent use both as a vehicle for the sponsor in an LP, and also as a vehicle for the fund, those entities are particularly interesting.

Spanish tax authorities declared in 1 March 2000 and 30 October 2001 rulings that the taxation principles applied to a U.S. LLC are similar to the transparency system in CIT rules.

The wording in the second draft of the new rules includes in the regime entities that are not subject in their state of domicile to a tax similar to Spanish CIT. That makes tax advisers more comfortable to conclude that U.S. LLCs and U.S. LPs fulfil the necessary requirements to be considered transparent entities under the new rules.

[14]There is an exception for Spanish real estate transferred by entities with no presence on Spanish territory, but with nonresident partners. The purchaser has a duty to withhold tax on the part of the price allocated to the nonresident partners.

As explained above, the new rules now refer to foreign entities with a similar or identical legal nature to the Spanish entities traditionally covered by the regime. It seems that the definition would leave out U.S. LLCs and would raise serious doubts about certain U.S. LPs whose legal form shares certain common characteristics with certain Spanish entities (for example, *sociedades comanditarias*) that are regarded as corporations and, thus, excluded from the tax transparency regime.

Generally, a tax regime based on the legal nature of the entities, when applied to foreign entities, creates a number of difficulties. That is true especially when, as is the case for the United Kingdom or the United States, the legal order regulating the entity's characteristics and functioning is entirely different from the Spanish system. If legal cultures differ widely, the comparison of legal characteristics of entities will be tainted with uncertainty. Ultimately, foreign investors may distrust which tax regime applies to their investments in Spanish targets.

The authors believe that the tax authorities' rulings and the initial drafting of the new rules were trying to follow tax transparency principles. However, the final draft of the law missed a good opportunity to clarify the taxation principles applicable in those cases, and to give the appropriate legal backing to the tax authorities' rulings. Now on one hand, private equity investors face a number of rulings from the tax authorities analyzing the tax treatment of the investment vehicle considered in its state of domicile to determine its tax treatment in Spain. On the other hand, newly approved legal provisions state that the legal nature, not the tax treatment, of the investment vehicle is the key factor to determine whether Spain will treat those vehicles as transparent.

Apart from the difficulties that a literal reading of the new rules undoubtedly creates, there may be practical limitations for the use of U.S. LLCs or U.S. LPs because those entities would need to prove their transparency status to a Spanish company paying income to the LLC or LP. Although strictly speaking, this last point is a formality, in practice it can create real problems for nonresident investors because the approach adopted by the Spanish tax authorities can be overly formalistic.

Tax practitioners must wait for interpretation of the new rules by the tax authorities. On the basis of previous rulings, observers expect the tax authorities to take the view that the new rules also are applicable to foreign entities, such as U.S. LPs and U.S. LLCs, which are fiscally transparent, even when technically they are not comparable to Spanish civil law partnerships. Until those rulings are issued, the authors recommend that taxpayers use care in choosing their entity type.

## V. Practical Analysis of the New Rules and Their Application to an Investment in Spanish Assets

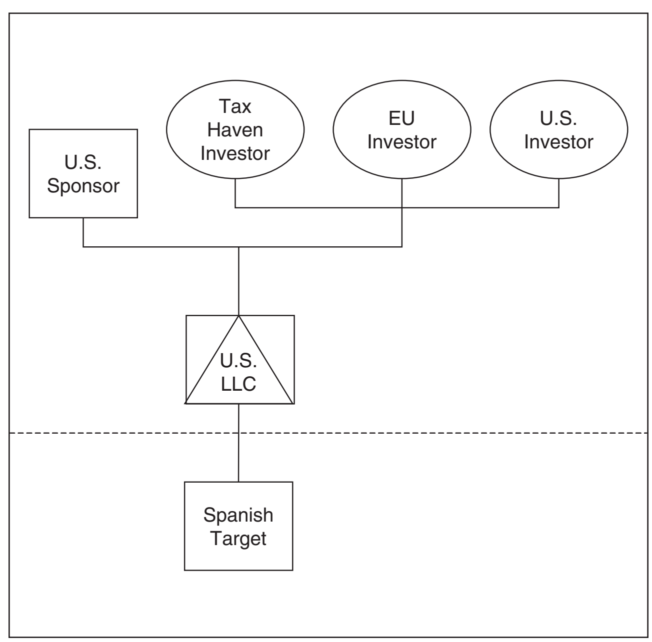
This article analyzes a number of questions below, which the authors believe arise under the new rules in connection with a basic private equity structure with a fund organized as a U.S. LLC with partners from various jurisdictions.

The authors will explain that the use of holding companies is advisable in certain cases, where the formal requirements to prove the state of residence of the fund investors make compliance with the new rules unduly cumbersome. The uncertainty about whether the new rules apply to U.S. LLCs and LPs is an additional reason to consider the use of that type of holding corporation.

The situation analyzed in Diagram 2 contains the following special features: A U.S. LLC acts as an investment fund with a U.S. tax resident sponsor, and with limited partners residing (i) in the United States, (ii) in the European Union, and (iii) in a jurisdiction classified under Spanish law as a tax haven. The fund acquires a holding in the share capital of a Spanish target company. For the present purposes, the authors are assuming that the fund does not have a PE in Spain and cannot be deemed as having a presence in Spanish territory. The authors also are assuming that the fund does not carry out any other activity in Spain.

The authors will, under a liberal interpretation of the new rules, assume that for this example, the new rules are applicable to U.S. LLCs.

*Diagram 2*



### A. Dividend Income

The Spanish target company paying out dividends must withhold tax at 15 percent, unless the U.S. LLC can prove (i) that the U.S. LLC is a transparent entity with no presence in Spanish territory, and (ii) the states of residence of each of the partners in the U.S. LLC and the proportion of income that must be allocated to them.

The first point is not expressly stated in the new rules and can create considerable practical difficulty. The U.S. LLC will normally not be able to obtain a U.S. tax residence certificate. The only way the U.S. LLC may prove its U.S. tax residency and status will be through the check-the-box election exercised by its partners.[15]

Assuming that is sufficient proof, or that a declaration from the U.S. LLC on its tax status would be enough, the second point, relating to the fund's partners, would require the U.S. LLC to obtain a tax residence certificate from each of its partners. In those certificates, the tax authorities of the states of domicile of each of those partners would declare that their residence is within the terms of the relevant treaty. Those certificates, together with a declaration from the U.S. LLC of the share of income allocated to each partner, must be given to the Spanish target company.

The dividends would then reach the U.S. LLC:

- minus the withholding tax rate corresponding to the U.S.-Spain treaty, for the income corresponding to the U.S. partner;
- minus the withholding tax rate applicable under the treaty between the EU investor's state of domicile and Spain for the income allocated to the EU partner (the following paragraph addresses the application of the EU parent-subsidiary directive); and
- minus the withholding at the general statutory withholding tax rate, for the income corresponding to the partner residing in a tax haven.

The authors believe that under the new rules as presently drafted, the EU partner should be entitled to claim the parent-subsidiary directive benefits, if the indirect holding it maintains in the target company's share capital fulfils the minimum holding and time period requirements. Although that approach, based on tax transparency principles adopted by the new rules, can be hindered by formal requirements: for example, compliance with the directive's definition of an EU parent company because the partner of the U.S. LLC will not be a direct shareholder of the Spanish subsidiary company.

### B. Capital Gains

As previously discussed, the U.S. LLC will not have to file a tax return for the gain realized on the disposition of shares held in the target. Because capital gains are not subject to the withholding procedure, taxation of those gains in Spain will be determined in accordance with the personal characteristics of each of the partners in the U.S. LLC.

The U.S. partner then will file the NRIT tax return and pay a 35 percent tax on the capital gain. There is an exception if the holding in the share capital of the Spanish target attributed to the partner is below 25 percent, or if the holding reaches that threshold, but the holding was held for less than 12 months preceding the sale. In the last case, according to article 13 of the U.S.-Spain treaty, the United States has the exclusive right to tax the capital gain from the sale of the shares in the Spanish target. The gain would be exempt in Spain. The U.S. partner, however, would need to provide a U.S. tax residence certificate.

The EU partner should be exempt, either under the application of the relevant treaty or under a domestic exemption. Spanish law provides for capital gains obtained by EU residents to be exempt from NRIT under certain circumstances.

The partner residing in a tax haven will be required to pay NRIT at the 35 percent rate.

### C. Carried Interest

Neither the new rules nor any domestic rules contain specific provisions to classify and determine the tax consequences of the carried interest allocated to the sponsor. The concept of carried interest is indeed unusual, both for Spanish legal commentators and for Spanish tax authorities.

Unfortunately now only questions can be raised and few answers can be provided. For instance, does the fact that the new rules require that the entity's income be allocated to each partner mean that the sponsor's share must include the carried interest? From that viewpoint, the share in the profits corresponding to the other partners would be reduced, and the carried interest would retain its character as dividend or capital gains. On the other hand, should the carried interest be classified as remuneration for services and, therefore, where appropriate, fall within the business income provisions of the relevant treaty?

At present, because there is little guidance from the rules' authors and no legal developments to help shed light on the issue, the article's authors favor the second interpretation — the carried interest would be treated as a fee paid by the fund to the sponsor. That would allow for the fund's income to be allocated to the

[15]That is assuming that no subsequent election to be treated as a corporation has been filed. Elective change may be made at any time after 60 months from the effective change of the prior election.

partners in direct proportion to their participation in the fund, without altering that participation as a result of allocation to the sponsor of the carried interest. However, it seems difficult to argue that, for withholding tax purposes, profits derived by investors in the fund must be calculated net of the carried interest paid to the sponsor. That point, unfortunately, will be left open for discussion until the Spanish tax authorities have been consulted and they issue rulings.

### D. Use of Holding Companies

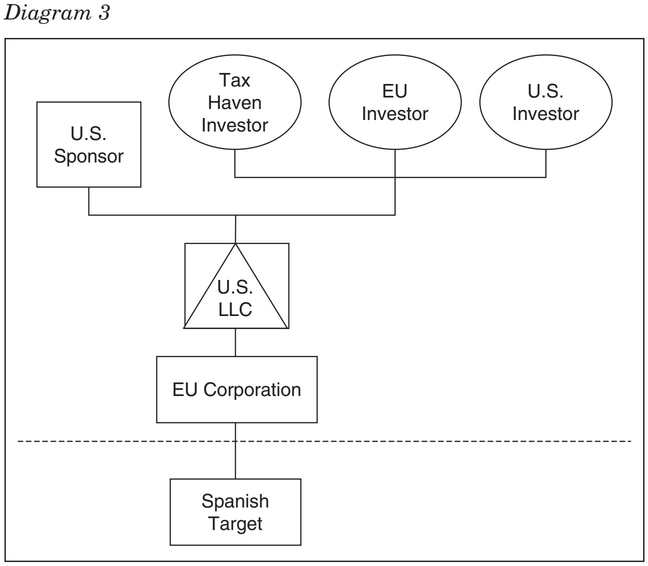
As explained above, the use of U.S. LLCs or any other transparent vehicles in private equity investments can prove to be an efficient measure. That is because it would allow one of the basic objectives of the structure — that partners in the private equity fund may claim the application of the treaty between their state of residence and Spain.

However, that may be insufficient for effective tax planning of the investment, either because some of the partners are not protected by a treaty or because the treaty rules may not always allow for tax-free dividends, or may not always adequately protect capital gains. For example, capital gains may not be protected when they are derived from the disposal of significant shareholdings.

In other situations, difficulties may arise from tax compliance and formalities imposed on the members of the entity and, especially, the excessive rigidity of the system for proving the tax residence of partners if certificates are required. Taxpayers may find the cumbersome formalities impossible to comply with in cases of investment funds with a great number of partners, or with a flexible and varying partner structure.

In those cases, a possible solution may be to use separate vehicles for different types of investors or, in more general terms, to include a vehicle between the fund and the Spanish target.

*Diagram 3*




Those structures must meet a series of requirements if they are to offer efficient solutions to the tax planning issues relating to the investment:

- The structure must ensure that Spain will allow dividends and capital gains to benefit from the reduced tax rates established in the treaties and in domestic law — without treating the holding company as transparent. It may be especially difficult to apply the parent-subsidiary withholding tax exemption for dividends, due to the antiabuse provisions applying to intermediate companies.
- The holding company must be exempt in its own state of residence from taxation on dividends and capital gains derived from holdings in Spanish targets. To that extent, there are several European jurisdictions providing tax exemption mechanisms for holdings in foreign companies, if that requirement is satisfied.
- The holding company used must be disregarded or fiscally transparent for U.S. tax purposes to ensure that the underlying income retains its character for U.S. tax purposes.
- The income must be distributed to the fund without being subjected to withholding tax in the state of source. In that respect, some jurisdictions may allow for structures with debt or hybrid formulae, if repatriation of benefits to the fund without withholding tax can be achieved, while, at the same time, the income can retain its character for U.S. tax purposes.

## VI. Conclusion

The new rules provide for a regime applicable to transparent entities that, in certain cases, will allow the partners in those entities to claim the benefits under the treaty between each investor's state of residence and Spain.

That tax transparency principle will not be applicable to transparent entities having a presence in Spanish territory. The definition of "a presence in Spanish territory" is similar to but not entirely consistent with that of PE, so that the facts of each case will need to be carefully assessed to determine to what degree the entity may be treated as being present in Spain.

The new rules have adopted a definition of the foreign entities eligible for the tax regime that does not refer to a tax transparency mechanism or to the tax treatment received in the state of domicile but rather to the legal nature of the entity. That analysis makes the inclusion of foreign entities (for example, U.S. LLCs or LPs) that are not easily assimilated to Spanish transparent vehicles especially difficult. In addition, the use of vehicles with neutral taxation, allowing for a simplification of the formality requirements and the overall tax analysis of the structure, still will be needed in many situations. ✦