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In this article, Suárez and Flores consider recent draft legislation that offers tax incentives to attract investors and workers to Spain's digital sector.

The Spanish government has just published a draft of its first start-up law (Proyecto de Ley de fomento del ecosistema de las empresas emergentes), which aims to promote innovative entrepreneurship and attract investment and talent to Spain. The start-up law is one of the key reforms included in the Spanish recovery plan (Plan de Recuperación, Transformación y Resiliencia) adopted by the Spanish government and the European Commission for the disbursement of European funds.

In the new digital age, start-ups have become a key element in facilitating a dynamic economy. Start-ups generate highly skilled jobs and usually achieve fast growth in a very short period. Yet, at the same time, they generally have riskier business models, which make financing and attracting and retaining talent a major challenge.

With the goal of properly responding to these needs, the Spanish start-up law creates a new legal framework with significant tax benefits to adapt the regulatory system for some companies, especially in their early stages.

I. Definition of a Start-Up Company

The law includes a definition of the type of start-up company that can benefit from its measures. Qualifying start-ups are Spanish companies or permanent establishments of foreign entities that have been established in the last five years, or seven years for biotechnology, energy, or industrial companies, and for companies whose technology has been fully developed in Spain.

A start-up is further defined as a company with annual revenue below €5 million, that does not distribute or has not distributed dividends, and is not listed on a regulated stock exchange. Further, 60 percent of the company's workforce must have employment contracts in Spain. Finally, either the products of the entity or its business model must be considered novel.

The law points out that qualifying companies may not have arisen from a merger, spinoff, or transformation. Moreover, for a start-up venture to be qualified as such, a public body (Empresa Nacional de Innovación SA, or ENISA) must validate that the entity qualifies under the start-up law. The manner in which qualification is requested and the associated process for validation are not covered by the law as these details are usually addressed by lower-tier regulations.

A specific shareholder can participate in up to three start-ups consecutively and still benefit from the law (that is, the fourth venture cannot enjoy the benefits). The preliminary draft of the start-up law (published in July 2021) did not include this reference, and, although the propriety of such a provision is arguable, in our view this reference is perhaps a bit too vague — as the law should

probably refer to the founders rather than the shareholders.

While limiting the business angel personal income tax (PIT) deduction (addressed in Section II.A.3) in the case of serial founders is arguably reasonable, it is not advisable to extend its application to other benefits, such as those applicable to employees or other investors. The current wording of the draft disqualifies an otherwise eligible entity when one of its shareholders (even a minority shareholder) has participated in three previous start-ups. This does not sound right to us based on our experience in the Spanish start-up ecosystem.

II. Tax Measures

One of the core concepts of the start-up law is the inclusion of targeted tax benefits. Before considering the specific provisions, however, it is worth noting that the draft law contains two sets of measures: one that can be used by any entity or individual, and a second that applies only to start-ups that have been validated by the relevant authority. Notably, only validated start-ups are eligible for the specific tax measures discussed below, but for the sake of brevity we refer to all entities that can benefit from the law simply as start-ups.

A. Measures for Start-Up Companies

1. Reduced Income Tax Rates

The law reduces the corporate income tax (CIT) or nonresident income tax (NRIT) applicable to PEs from 25 percent to 15 percent. This reduced rate will be applicable in the first tax period in which, while qualifying as a start-up, the taxable income is positive, and in the following three tax periods, provided that the entity still qualifies as a start-up.

No installment payments for CIT or NRIT will be required for start-up companies, which will help with their short-term liquidity. Furthermore, if a start-up has positive taxable income, the law allows it to defer (between six and 12 months) the payment of the CIT and NRIT tax debt. The deferment will be allowed at no financial cost since no delay interest would accrue in connection with these tax debts.

Although these are positive measures, many start-up companies have negative taxable income in the first few years, and sometimes even well after the five to seven years identified in the start-up law have elapsed. Thus, the effective benefit of this measure will probably be somewhat limited.

2. PIT Exemption

The PIT exemption for income attributable to the exercise of stock options or delivery of shares to employees is increased from €12,000 (the general threshold) to €50,000 (the threshold applicable to start-ups) per year.

Additionally, for start-ups, the requirements for the delivery of shares or stock options are more lenient compared with regular companies. In the latter case, the delivery policy would have to apply to all employees, not just a subset or a fraction.

Furthermore, the taxation of income exceeding the €50,000 threshold (which for PIT purposes is considered employment income) is postponed until the liquidity event (that is, an initial public offering or exit of the company) or a maximum deferment period of 10 years. This deferral allows dry taxes (that is, those that are connected to income in which the right or asset received is not monetary or liquid) to be kept to a minimum. Thus, these are indeed positive measures, as stock-related remuneration is the norm in most start-up companies.

Notwithstanding these positive measures, in Spain the labor incentives linked to start-ups are commonly channeled through phantom stock options (that is, monetary compensation) payable at the exit event, rather than pure stock options for the delivery of shares; this is done to avoid corporate governance issues, as phantom stock options have no voting or political rights associated with them (no real shares are delivered). The beneficial regime described above regulates the cases in which actual shares are delivered to the employees before the exit event; thus it is likely that the effective content of that provision will be smaller than anticipated.

For context, the difference between acquiring actual stock before the exit event and being paid phantom stock remuneration at the exit event is significant: The increase in value of the start-up between the moment the employee obtains the actual shares and the exit event is captured by PIT as capital gains, taxed at lower rates (19 to 26 percent), as opposed to phantom shares, for

which remuneration will be considered employment income (thus taxable at a rate of up to 51 percent depending on the Spanish region in which the employee resides).

Notably, a safe harbor for start-ups will now be defined in relation to the value of the shares acquired. Given the volatility of the value of start-ups, and the successive rounds of financing that usually take place, this typically has been a clear area of conflict. Therefore, the solution proposed in the draft is well received. The computed value will be the one used in the financing round before the delivery of the shares; if no financing rounds have taken place, the ordinary regime market value will be used.

Regarding the valuation of those shares, while linking the value used in the financing round is a positive change, in our view, it would have been better if the draft had referenced preferred or common stock values — as there can be significant differences between these two. For reference, we can take the example of the U.S. section 409A valuation, in which the enterprise value usually sits below market value, therefore providing more value to the employees who will become shareholders.

3. Business Angel Deduction

The start-up law amends the PIT deduction linked to investment in newly established companies, also known as the business angel deduction. While these new companies do not need to be start-ups, there are more benefits if they are.

In general newly established companies are defined as those established in the previous five years, or in the case of qualifying start-ups with a seven-year eligibility period, the last seven years. The provision increases the maximum deduction base to €100,000 (currently €60,000) and the deduction rate up to 50 percent (currently 30 percent). Under this deduction, the investor typically cannot hold more than 40 percent together with close relatives, but in the case of start-ups this participation threshold is lifted (that is, in the case of start-ups, a 100 percent stake would be valid).

4. Inbound Expatriate PIT Regime

Finally, a director of a start-up who holds a stake higher than 25 percent (that is, they are a related party vis-a-vis the entity) will be allowed to sign up to the inbound expatriate PIT regime, as indicated by the general information about this special regime included in Section II.B.3.

B. Measures for Any Company or Individual

1. Business Angel Deduction

As previously discussed, the start-up law enhances the business angel deduction. This enhancement applies not just to start-ups but to all companies, with exceptions.

2. Exemption of In-Kind Remuneration

Nonresidents may benefit from the exemption of in-kind remuneration set forth under the PIT law, such as medical insurance, stock options (up to €12,000 or, in the case of start-ups, €50,000 annually), meal vouchers, and so forth (this was not possible before). This is an interesting measure as one of the objectives of the start-up law is to attract nonresident workers to Spain (mainly the so-called digital nomads who work remotely for entities that are not based in Spain).

3. Inbound Expatriate Regime

The inbound expatriate regime (also known as the Beckham regime) will also be modified so that the number of tax periods examined, prior to the taxpayer's relocation to Spain, is reduced from 10 years to five years, thus simplifying access to the regime.

Although the preliminary draft included language to increase the length of the benefits period from one-plus-five years to one-plus-ten years (that is, the tax period of the relocation plus the following five or 10 years), the current draft retains the current one-plus-five-year period.

One significant amendment is the extension of the regime to (1) workers who, whether or not ordered to do so by their employers, travel to Spanish territory to work remotely; (2) directors of start-ups, regardless of their percentage of stock (generally those who hold a stake of 25 percent or more are not allowed to enroll); and (3) the children under age 25 of the taxpayer and spouse or, in the absence of a marital relationship, the parent of the children to be taxed under the special regime, provided that they meet specific conditions regarding their taxable income level.

In our view, these amendments to the special regime are very positive measures — not only for

start-ups, but for all companies and workers from other countries who want to work in Spain. In the past, this issue was typically overlooked by potential newcomers, and more recently the Spanish regime had lost its competitiveness compared with similar regimes in neighboring countries.

4. Carried Interest

The start-up law clarifies the tax treatment of carried interest, which is now reflected as employment income. However, under the draft law a 50 percent PIT exemption over the carried interest will apply, provided that specific requirements are met.

It is a positive step forward that the tax treatment of carried interest is finally clear — there had been significant controversy concerning whether it should be considered employment income (thus subject to the more expensive tax rates) or savings income (taxed at around half the rates applicable to employment income). With the 50 percent exemption, a similar taxation level achieved. This is good news for venture capital and similar sectors.

III. Measures Unrelated to Tax

The draft start-up law also addresses other beneficial regulations in the corporate, employment, social security, and regulatory sectors. For example, the draft addresses:

- the potential extensive use of sandbox regimes (until now exclusively available to the fintech sector, but now available for a one-year period in other regulated sectors);
- the reduction of paperwork, especially upon incorporation and other corporate actions;
- the inapplicability of the mandatory requirement to wind down business due to losses during the first three years;
- the regulation of student start-ups;
- the reduction of social security costs; and
- streamlined visa procedures for start-up workers.

IV. Final Assessment of the Draft

The tax measures included in the start-up law are good and may further fuel the Spanish start-up sector, mainly because they are also applicable to foreign corporations that have PEs in Spain.

Perhaps in response to unfounded IP investor concerns, we have seen cases in which start-ups end up having to change their legal headquarters to the United States or the United Kingdom. Thus, the way these incentives are being established is well planned. In fact, it is worth noting that the draft law is the result of intense discussions between the cabinet and stakeholders in the start-up sector that commenced in July 2021.

Although the current Spanish government does not have an absolute majority in the parliament, in our view the law will most likely be passed; the opposition has shown interest in it, and there is significant interest from stakeholders in the start-up sector.

Nevertheless, amendments to the draft can still be made during the parliamentary process, although considering the consensus on the draft, it is likely that only minor amendments will be made.

In our view, the final text of the start-up law is likely to be passed in the second half of 2022, with most of the tax measures coming into force as of January 1, 2023. ■