New administrative criteria regarding Spanish REITs

In order to boost the Spanish rental market Law 11/2009, of 26 October (the "**SOCIMI Law**"), created the Spanish Real Estate Investment Trusts in 2009 ("**SOCIMI**"). The SOCIMI Law was subsequently modified in 2012[1], which significantly enhanced the application of this regime.

The SOCIMI scheme includes complex corporate and tax rules. Accordingly, with the aim of analysing and clarifying the SOCIMI special regime, the Spanish General Directorate of Taxes ("**GDT**") has issued several tax rulings in the last few years.

In this regard, on December 2014, the GDT issued a new tax ruling[2] (the "**Tax Ruling**") which, in addition to reiterating the criteria included in previous tax rulings, establishes a new administrative criterion regarding the SOCIMI regime.

In this memorandum, we will analyse the main changes included in the Tax Ruling.

1. Requirements to be met in order to apply for the SOCIMI regime

(i) Asset test

According to the SOCIMI Law, 80% of the SOCIMI's assets must be qualifying real estate assets and/or shares. In this regard, the GDT states that not all the assets related to rental activity shall be taken into account for the "asset test". For instance, deferred tax assets or receivables related to rental payments shall not be taken into account in this calculation.

Furthermore, the real estate assets shall be determined by means of their gross acquisition values (i.e. without taking into account any reductions in their value for impairments or depreciation).

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1 Law 16/2012, dated 27 December.
2 Number 3308-14, dated 11 December 2014.

(ii) Income test

Regarding the calculation of the minimum threshold of 80% of income corresponding to qualifying rental activities, the GDT clarifies that, for each property, expenses directly related to the relevant lease and a proportional percentage of overhead expenses could be deducted from the relevant income[3].

Additionally, income obtained through the sale of shares and real estate assets before the three-year minimum holding period would be calculated as “bad income” for the purposes of this test, regardless of the reason for their sale.

Finally, the GDT also clarifies that the thresholds shall be calculated according to Spanish accounting rules and, therefore, IFRS[4] rules for consolidated accounts are not applicable[5].

(iii) Mandatory dividend distribution

The GDT has stated in previous tax rulings that the mandatory dividend distribution could be paid in cash or in kind.

Furthermore, as analysed in the Tax Ruling, after approval of the dividend distribution, the receivable could be capitalized (via a share capital increase). In such an event, if the dividend is considered as income for the shareholders, the requirements related to the mandatory dividend distribution would be considered as having been met.

(iv) Loss of the SOCIMI regime

The SOCIMI Law sets forth the following:

- If a company that has opted for the SOCIMI regime fails to meet the requirements established by the SOCIMI Law once the two-year grace period has elapsed, the company must pay the relevant CIT quota (i.e. the difference between the tax quota resulting from application of the general regime and the quota resulting from the SOCIMI regime), plus delayed interest and, as the case may be, penalties.

- If the company loses its SOCIMI status, it cannot opt for this status again for a period of three years.

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3 This criterion was already included in a ruling issued in February 2014 (number 0346-14, dated 11 February 2014).
4 International Financial Reporting Standard.
5 Again, this criterion was already included in a ruling issued in February 2014.

However, the GDT establishes that the rule which prohibits a company from applying for this regime for three years does not apply in the following scenarios (due to the fact that the SOCIMI regime was never effectively applied):

- When the loss of the SOCIMI status is due to failure to meet the requirements within the grace period.

- When the company waives its SOCIMI status before the filing of the first "SOCIMI CIT return" (before July of the following year in the case of tax periods coinciding with the calendar year).

Finally, regarding the infringement of the income test in a given tax period "*n*" which is subsequently not remedied in the following year "*n+1*", the loss of the regime has effect from "*n*" (and the three-year period in which the company cannot opt again is also calculated from that period).

(v) Change in the type of SOCIMI

According to the Spanish SOCIMI Law, the SOCIMI regime can be applied by either:

- a Spanish listed company, or
- a non-listed Spanish company that has a foreign listed REIT as a sole direct shareholder.

In this regard, the GDT sets forth that if a Spanish company has opted for the SOCIMI regime without being listed at that point, and if the company is acquired by a foreign REIT *a posteriori* during the two-year grace period, the SOCIMI regime would still be applicable.

2. 19% "special tax": minimum 10% taxation of significant shareholders

The traditional approach taken by the GDT was that the calculation of the minimum 10% level of taxation applicable to the significant shareholders (i.e. shareholders having at least a 5% stake) in order for the 19% "special tax" not to be triggered should be made by taking into account the gross tax due on the dividend, offset by any international tax credits/exemptions arising from the dividend income.

However, the Tax Ruling reflects a more restrictive calculation mechanism in comparison to previously issued tax rulings. The GDT clarifies that despite the fact that taxation of the dividend should be analysed without considering any circumstances of the shareholder other than the dividend itself (e.g. ignoring the shareholder's potential use of tax loss carryforward), the calculation must take into account any expense directly associated with that dividend (i.e. costs arising from the management of the stake, <u>as well as financial expenses arising from the acquisition of the stake).</u>

In our opinion, this novelty is without doubt the most important of the Tax Ruling and should be carefully taken into account in SOCIMI structures, given that in most cases the SOCIMI non-resident shareholder is in a financial *back-to-back* position. In such a case, the requirement of the level of taxation would not be met in accordance with the new criterion of the GDT and thus the 19% "special tax" would be triggered.

Moreover, according to the GDT, if the direct shareholder of the SOCIMI is a look-through entity, the requirement related to the 10% minimum taxation must be analysed at the level of the second-tier shareholders[6].

3. Tax regime of the SOCIMI and its shareholders

(i) Double tax credits upon dividend distribution or participation disposals

According to the SOCIMI Law:

- SOCIMI shareholders that pay Corporate Income Tax ("**CIT**") or Non-Resident Income Tax ("**NRIT**") with a permanent establishment ("**PE**") in Spain[7] are not entitled to the current Spanish participation exemption[8] applicable to dividends and share disposals under certain requirements. Similarly, NRIT taxpayers without a PE are not entitled to the participation exemption set forth by article 14.1.i) of the NRIT Law for listed companies.

- In order to comply with the legal requirements, a two-year grace period is granted from the date in which the company opted for the SOCIMI regime.

In this regard, the GDT sets forth that, if the requirements for the application of the SOCIMI regime are not met during the two-year grace period, the shareholders could indeed amend their CIT tax returns in order to apply such exemption. Similarly, NRIT taxpayers without a PE could also apply the participation exemption under such circumstances.

(ii) Interim payments of CIT before the option for the SOCIMI regime

The first interim payment of CIT (filed in April) is usually made before the company in question applies for the SOCIMI regime (to be filed before 30 September each year for companies with tax periods that coincide with the calendar year, but once made, this option has retroactive effects from January). Based on the criterion of the Tax Ruling, the SOCIMI should request the relevant refund of this interim payment by means of the CIT return to be filed by July of the following year.

(iii) Reversal of non-deductible financial expenses

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6 This criterion was already included in tax ruling number 0346-14, dated 11 February 2014 and tax ruling number 1429-14, dated 29 May 2014.
7 Personal Income Tax ("PIT") taxpayers benefited from a EUR 1,500 exemption until December 2014 which no longer applies and, thus, we have not analysed this issue.
8 Set forth in article 21 of the new CIT Law, 27/2014. Until December 2014, this tax benefit was not an exemption but a double tax credit.

If a company has incurred in non-deductible financial expenses prior to the option to apply the SOCIMI regime, the reversal of such non-deductible expenses (i.e. negative adjustment of the taxable income) could be deducted from the income subject to the general CIT regime (i.e. disposals before the three-year holding period has elapsed)[9].

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9 This criterion was already included in the tax rulings number 0346-14, dated 11 February 2014 and number 1125-14, dated 22 April 2014.