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Spanish Tax Alert

Business purpose in leveraged buyouts

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1. Introduction

In view of the reasoning supporting both the Spanish Directorate-General for Taxation's Decision V0775/2015 of 10 March 2015, in a binding response to a taxpayer's query, and the Judgment of the Spanish Supreme Court of 26 February 2015 (Rec. 4072/2013) (Glaxo judgment), it appears that the analysis of 'business purpose' that should govern and underpin restructuring operations carried out by way of leveraged buyouts must be performed at two levels and at both such levels the aforementioned economic substance test must be passed.

Thus, to begin with, at what we could call 'level I', the existence of business purpose is determined by analysing whether the restructuring operation meets the objectives and requirements set out by the law for each case. After this first level, at what we could call 'level II', the specific transactions carried out for the restructuring are analysed to determine if they either conform to the objectives of such restructuring – thereby passing the economic substance test – or, otherwise, are unnecessary or superfluous to achieve said objectives.

2. Business purpose in the restructuring operation (level I)

In the case of the abovementioned binding response, the Directorate-General for Taxation analyses the operation by virtue of which the French parent company of a group purchases from an independent Spanish company a stake in the group's Spanish holding. Such acquisition, paid for with a combination of equity and external finance, is to be subsequently transferred to the group's controlling company, which would thus hold 100% of the holding's share capital in which it already has a stake. To do this, said company would receive a loan from another French company which, in turn, owns 100% of its share capital.

Now, at what we have called 'Level I', the Directorate-General for Taxation is of the opinion that there is business purpose in "cases of restructuring within the group, as a direct result of an acquisition from third parties, or cases where there is actual management of the investee from the Spanish territory."

For its part, the Supreme Court, in the Glaxo case, does not question the existence of business purpose in the restructuring operation (level I) because, as is apparent from the appellant's written closing statements, this was not even questioned by the inspectorate or by Counsel to the State, as recalled by the court, which states that "the consistency of business purpose in the general operation of restructuring and reorganisation of the two groups of companies is not a moot point", although, as we shall see, it is in the examination performed on the choice of the intragroup loan as a means of financing the operation (level II).

3. The economic substance of transactions carried out for the restructuring (level II)

In addition, the Directorate-General for Taxation, in the aforementioned query, believes that the transactions conducted for the restructuring meet its objectives and produce a number of effects and consequences from which one can deduce business purpose in the operation as a whole, such as the simplification of the shareholding structure of a group company, the simplification and streamlining of decision-making, greater strategic and financial flexibility of the business in Spain or the optimization of cash flows, among others.

For its part, in the aforementioned Glaxo judgment, once the economic substance test had been passed in respect of the general restructuring operation, the Supreme Court goes on to analyse the business purpose underlying the specific transactions made to carry it out, that is, the sale of shares by obtaining an intragroup loan, determining whether such sale and purchase is consistent with the intended purpose of the restructuring. Several issues arise in this regard, among which we should note the following:

a) Choice of transaction

In line with the transaction chosen to acquire the shares, choice around which the matter in dispute revolves, the Supreme Court posits, as does the appellant, that the Administration admits the reasonableness of the restructuring, but is of the opinion it should have been carried out by way of a non-cash consideration instead of resorting to an intragroup loan.

In this regard the Supreme Court finds that, the latter being one of the possibilities to carry out the operation, it is endowed with "market ordinariness and normality", which leads the court to the conclusion that, "regardless of the specific case, and in general", the mechanism used is normal and reasonable within restructuring processes, which clearly identifies in purchase and loan transactions the pursuit of goals other than purely tax-related ones. Thus, and although a tax advantage is procured through the chosen transaction, such advantage is not the only objective pursued in general, as others can be observed such as allowing the appellant to perform all the functions of the owner of the share capital and the group in Spain, providing it with the possibility of carrying out all the restructuring operations in the following years and thereby achieve an improvement in the group's management and profitability.

b) Impact on the operation of the non-taxation of interest

As for the non-payment of taxes on the interest by the Belgian undertaking, the Supreme Court regards it as information "of little consequence" for the purposes of characterisation and adjudication in the case at hand. The court holds, as stated in the decision of the Central Revenue Tribunal (abbrev. TEAC), that the fact that the interest was taxed or not (the Supreme Court assumes that it was not given the characteristics of coordination centres in Belgian law) serves only as an added piece of evidence, but not as a decisive element in establishing the existence of abuse of law (*frau legis*).

c) Burden of proof

The Supreme Court, after recalling the consequences of the phenomenon of tax avoidance by multinational companies through tax engineering, states that it cannot be inferred that "in all these cases there is abuse of law that must be challenged, but rather that each must be studies on a case-by-case basis." The latter, after analysing the transaction on trial, led the court to conclude that "it is the Administration which has to prove in this case that this mechanism has been used involving an abuse of law", a task that in this case the court found had not been sufficiently carried out, which led to an acceptance of the appellant's claims.

4. Conclusion

The above pronouncements, among which the judgment of the Supreme Court commented on stands out – as it is the first time that the court admits the existence of business purpose in a leveraged buyout following recent judgments pronounced in the opposite direction (9 and 12 February 2015) –, highlight that the analysis of economic substance should be performed at the two pointed out levels. So it follows that there is a gradual abandonment of the formalistic approach

whereby, the idea of simulation (sham) or abuse dispelled (for instance, in cases where shares of undertakings outside the group are purchased), the economic substance of the operation could be presumed, thereby accepting the deductibility of any interest that could arise upon the formalisation of an intragroup loan as a means of financing. In such context, it will now be necessary to also prove that the arranged transaction makes sense from a business point of view for the restructuring as a whole and taking into consideration all the parties involved in the transaction.

The Dutch Supreme Court has also recently expressed itself on the same lines in a judgment of 5 June 2015 concerning an operation like the one just described.[1] In this case the court holds that merely asserting a purchase of shares from third parties is not enough to attach business purpose to the whole operation, a criterion that involves overcoming its own thoughts in previous rulings and that ultimately leads the Dutch court to reject the deductibility of interest arising from the intragroup loan used to finance the operation.

[1] http://www.loyensloeff.com/en-US/News/Publications/Flashes/Pages/TaxFlash8June2015.aspx.