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Article 12(5) of the Spanish Corporate Income Tax Act (CTA)[1] has recently received a lot of attention. Article 12(5) CTA allows any company with a taxable base in Spain to claim as a tax deduction the depreciation of the financial goodwill arising from a foreign takeover.

According to some, this seemingly unique regime in Europe might amount to illegal state aid under European Community law. In that respect, Alyn Smith, a member of the Scottish National Party and a member of the European Parliament, has been the latest to call into question this alleged tax break in the context of the acquisition of the electric company Scottish Power by its Spanish counterpart Iberdrola.[2]

The European Commission has asked the Spanish government to phase out another tax benefit favoring Spanish export companies that are linked to investments abroad.[3] So far, the commission has not formally initiated proceedings against Spain concerning article 12(5) CTA[4] but, according to official sources, is carefully reviewing the tax regime's legality under EC state aide rules to determine whether to open an official investigation procedure.

This article offers a brief overview of the legal discussion that is taking place regarding Spanish companies playing a key role in major transnational takeovers. Accordingly, after a short description of the nature and function of the controversial tax regime, we will summarize its alleged impact in two particular foreign takeover cases, in which it reportedly implied an economic advantage for some Spanish companies investing in foreign undertakings. Then we will outline the main requirements to qualify as state aid under the EC Treaty rules and the rules' applicability to article 12(5) CTA in light of the commission's decisions and European Court of Justice case law.

Article 12(5) CTA

According to article 12(5) CTA:

> When a company acquires shares in a nonresident company, and whose dividends qualify for the exemption provided for in article 21, the difference between the acquisition price and the shares' book value at the time of the acquisition shall be attributed to assets and rights of the company not resident in the Spanish territory, following the criteria set up in Royal Decree 1815/1991, of 20 December, which enacts the rules for the elaboration of annual consolidated accounts. The part that

[1]Royal Legislative Decree 4/2004, of Mar. 5, 2004, on Corporate Income Tax.

[2]*Financial Times*, Feb. 24, 2007.

[3]Commission press release IP/06/355, "State Aid: Commission Requests Phasing Out of Spain's Tax Incentives for Investment Abroad," Mar. 22, 2006. The tax incentive consisted of a tax credit of 25 percent of the amount invested (i) to establish a foreign branch; (ii) to acquire a substantial shareholding of a foreign company; or (iii) to explore and penetrate new markets, as long as the investment was linked to the export of goods and services from Spain. The Spanish government agreed to phase out the benefit as of January 1, 2007.

[4]Nonetheless, it has already analyzed its potential effects on competition under its merger control authority. *See, e.g.,* commission decision in case M.4517, *Iberdrola/Scottish Power* (not yet published) and the corresponding commission press release IP/07/196, "Mergers: Commission Approves Planned Acquisition of Scottish Power by Iberdrola," Feb. 15, 2007.

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could not be attributed may be deducted from the taxable income, with the annual limit of a twentieth part of the amount, unless it had been included in the base for the deduction under article 37 of this Act, without prejudice to what it is established in the applicable accounting regulations.

In other words, when a Spanish company acquires stock in a foreign company, the financial goodwill (which would stem from the difference between the acquisition price and the share's book value that is not attributable to unrealized gains of assets and rights of the nonresident company) may be depreciated over a 20-year period.

To qualify for this tax deduction, the following requirements must also be met:

- The stock acquired must amount to at least 5 percent of the nonresident company's equity.
- The nonresident company must be subject to a tax regime equal or similar to the Spanish CTA.
- The nonresident company must carry out "business activities" abroad. This requirement may be assessed through the income obtained by the nonresident company in the last tax year. As long as 85 percent of its income originates from the sale of goods or services, the requirement will be deemed fulfilled.[5]

Once a Spanish resident company qualifies for the application of article 12(5) CTA, it should proceed as follows:[6]

- First, the company should take the acquisition price and subtract the book value as of the date of the acquisition of the stock. The book value represents the part of the equity or capital of the nonresident company corresponding to the acquired share, which is determined according to the annual accounts of the nonresident company.
- Second, the resulting positive difference will be attributed to unrealized gains of assets and rights of the nonresident company, with the limit of the fair market value of the different assets determined under the criteria established by Spanish accounting rules.[7]
- Third, the remaining difference will be deducted from the taxable income with an annual limit of one-twentieth of the corresponding amount.

As it may be inferred, this tax deduction is likely to be available only in targeted cases. Indeed, the general principle under the CTA would be the nondepreciation of financial goodwill. However, there are two exceptions to this rule. The first one is the tax regime at stake, and the second one may be found in the framework of full mergers, under article 89 CTA, which, in contrast with article 12(5) CTA, requires that the target company cease to exist.

In parallel, and taking into account the close relationship existing between Spanish corporate income tax and accounting rules under CTA (the corporate tax base takes the net profit as a starting point), Spanish accounting regulations also support this general principle of nondepreciation of the financial goodwill. The Spanish Accounting and Auditing Institute (Instituto de Contabilidad y Auditoría de Cuentas, or ICAC) clearly established in its decision of January 21, 1992 (concerning valuation rules for intangible assets), that the accounting treatment for the goodwill would not be applicable for the acquisition of shares or stock in other companies.[8]

As a result, and as pointed out by the Spanish Tax Authority (Direccion General de Tributos, or DGT), the tax allowance under article 12(5) CTA does not have to be reflected in the company's annual accounts.[9]

Finally, to further characterize the tax regime established under article 12(5) CTA, it is worth noting the recent report issued by the DGT[10] at the request of the Spanish Securities and Financial Markets Authority (Comisión Nacional del Mercado de Valores, or CNMV). From a technical point of view, the permanent or temporary nature of this tax benefit has been under debate.[11] As the DGT states

[5]For further details on this last requirement, see Manuel Gutiérrez Lousa and José Antonio Rodríguez Ondarza, "Los incentivos fiscales a la internacionalización de la empresa española," 825 *Nuevas Tendencias en Economía y Fiscalidad Internacional* (2005), pp. 60-61.

[6]Spanish Tax Authority (Dirección General de Tributos, or DGT), Binding Ruling 2245/06, Nov. 10, 2006.

[7]General Accounting Plan (Plan General de Contabilidad, or PGC), enacted by Royal Decree 1815/1991, of Dec. 20, 1991.

[8]The book value of financial investments will be assessed according to valuation rule 8 of the PGC, *supra* note 7; that is, according to their acquisition price.

[9]DGT Binding Ruling, *supra* note 6. It should be pointed out that the forthcoming reform of the PGC does not provide for the depreciation of the goodwill under any circumstances. For further information, see E. Ortega Carballo, "La reforma del PGC: anotaciones de ultima hora," 236 *Estrategia Financiera* (2007).

[10]*Id.*

[11]For further information, see P. Ulecia Rubio, "Consideración de la amortización del fondo de comercio financiero del artículo 12.5 LIS como diferencia temporal (NIC 12 parrafo 5)," 14 *Actualidad Juridica Uria Menendez* (2006), at 79.

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in its report,[12] article 12(5) CTA constitutes a valuation change for tax purposes that implies a tax adjustment to the net profit. This value change (consisting of the allowance for the financial goodwill) affects the tax value of the share that, when transferred to a third party, will cause the reversion of the tax allowance. In other words, when the share is transferred, all the tax deductions applied to the tax base in previous years under article 12(5) CTA will have to be included to calculate the tax gain.

Thus, according to the DGT, article 12(5) CTA implies only a deferment of the corporate tax liability, which will revert at the time the shares that gave rise to the financial goodwill are disposed.[13]

The Alleged Last Straws

Since its enactment,[14] article 12(5) CTA has triggered the concern of many economic agents from other EU member states. Many have claimed that this provision has enabled and overstimulated Spanish companies' foreign investments, such as:

- the acquisition of the British credit institution Abbey National by the Spanish bank Santander Central Hispano (2004);
- the takeover of the British mobile operator O2 by Spanish telecom incumbent Telefónica (2005);
- the acquisition of the British airports operator BAA by the Spanish infrastructures company Ferrovial (2006); and
- the takeover of Scottish Power by Iberdrola (2007).

After the acquisition of O2 by the Spanish company Telefónica for €28 billion, Deutsche Telekom, the second bidder in the takeover, publicly accused the Spanish government of subsidizing foreign acquisitions by Spanish companies, contravening EU law.[15] According to Deutsche Telekom, under, *inter alia*, article 12(5) CTA, Telefónica would be able to write off €11 billion from its tax return, reducing by €4 billion its tax liability (which constitutes 15 percent of the price paid for its share of O2).[16]

The planned acquisition of Scottish Power by Iberdrola for €17.3 billion has been of great interest. Politicians and economic operators have shown their unrest concerning the conditions under which Iberdrola was bidding for Scottish Power. Alyn Smith has been one of the most active parties seeking to impede the transaction.[17]

As a result, the commission studied the alleged economic impact of article 12(5) CTA in the framework of its merger control review of the transaction. The Spanish tax incentive at stake is described, together with the 25 percent tax credit that the Spanish government has agreed to phase out, as allowing Spanish companies purchasing shareholdings in foreign companies "to amortize the cost of financial goodwill and to offset up to 12 percent of the price paid against tax to the extent to which the purchase leads to increased export activities."

> ***Deciding whether the tax incentive is a specific or selective measure is pivotal to determine its characterization as state aid.***

Under the EC merger regulation,[18] the commission had to assess whether these incentives could increase the financial strength of the merging parties to an extent that, in combination with other relevant factors, the merger would significantly impede effective competition on the "energy markets concerned." This was not found to be the case:

> Looking at previous acquisitions by Iberdrola, it may be that a tax benefit of up to 10 percent of Scottish Power's 2006 turnover could follow from the incentives. However, even were this to be the case here, the resulting financial strengthening of the company would not lead to a threat to effective competition on U.K. or Spanish energy markets (Scottish Power has no current or planned activities in Spain), because of the limited scope of the parties' activities and the strength of competitors.[19]

It is important to note that the commission does not consider that the economic benefits that could follow from the incentive in article 12(5) CTA could "lead to a threat of effective competition on U.K. or Spanish energy markets."

However, the European Commission did not rule out the future scrutiny of the tax provision under EC state aid rules:

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[12]DGT Binding Ruling, *supra* note 6.

[13]*Id.*

[14]Act 24/2001 of Dec. 27, 2001, on Tax, Administrative, and Social Measures.

[15]*Financial Times*, Nov. 11, 2005.

[16]*Id.*

[17]For further information, see http://www.alynsmith.eu.

[18]Council Regulation (EC) 139/2004 of Jan. 20, 2004, on the control of concentrations between undertakings (the EC merger regulation), OJ L 24, Jan. 29, 2004, pp. 1-22.

[19]Commission press release IP/07/196, "Mergers: Commission Approves Planned Acquisition of Scottish Power by Iberdrola," Feb. 15, 2007. (The commission's clearance decision is not yet available.)

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> This conclusion is unaffected by the question whether or not these incentives constitute state aid under the EC Treaty, because the Commission's assessment of the proposed transaction under the Merger Regulation must be based on whether the merging parties could impede effective competition.[20]

Indeed, the efforts invested have effectively contributed to the close scrutiny of article 12(5) CTA.

EC State Aid Rules

Recently, harmonization in the field of direct taxation has become a never-ending subject for discussion in Brussels, with a few significant legislative developments such as the parent-subsidiary directive and the savings directive. But it is also one of the most difficult to deal with because some EC member states have shown that they do not want to relinquish sovereignty over direct taxation.

Yet EC member states do not enjoy complete freedom when setting the scheme and functions of their corporate tax systems. EC state aid rules, provided by article 87 of the EC Treaty,[21] constitute an important boundary on the ability of EC member states to define their tax policy, particularly the tax incentives they offer to undertakings with a tax base in their territory.

According to the commission's decisions in this field, there are four cumulative conditions that must be met to qualify as state aid:

- Are state resources involved?
- Does a selective advantage exist?
- Is Community trade affected?
- Is the measure justified by the nature of the tax system?

Loss of Tax Revenue

The possibility of depreciating the financial goodwill during a 20-year period provided under article 12(5) CTA is not a permanent tax benefit but a deferment of the tax that should be paid when the share in the foreign company is transferred.

Despite the nature of this benefit, according to the commission notice on the application of the state aid rules to measures relating to direct business taxation, a tax deferment may imply a loss of tax revenue equivalent to the consumption of state resources in the form of fiscal expenditure.[22]

Thus, in our case, the tax deferment will easily trigger a loss of tax revenue given the time value of money.

Selective Advantage

Deciding whether the tax incentive is a specific or selective measure is pivotal to determine its characterization as state aid.

Prima facie, no selectivity arises from this advantage, since the incentive provided is available to any company with a taxable base arising in Spain.[23] In that regard, the commission usually excludes in principle from the concept of state aid tax measures of a purely technical nature — setting the rate of taxation, depreciation rules, and rules on loss carryovers, provisions to prevent double taxation or tax avoidance. Further, the commission points out that "the fact that some firms or some sectors benefit more than others from some of these tax measures does not necessarily mean that they are caught by the competition rules governing state aid."[24]

Nevertheless, besides standard cases (such as measures restricted to some economic sectors or types of companies),[25] the commission has also examined measures that were not formally restricted but turned out to be very selective.

In particular, the commission has stressed that rules laying down requirements relating to establishment in a specific number of foreign countries[26] meet the selectivity criterion. In one case, the commission even indicated that a measure could be regarded as selective because the conditions for benefiting from the tax concessions required some economic strength.

As pointed out by the commission, "measures open to all sectors can, nonetheless, be regarded as selective where the eligibility criteria in practice restrict the potential number of recipients. This is

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[20] *Id.*

[21] Article 87 EC Treaty: "Save as otherwise provided in this Treaty, any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods shall, in so far as it affects trade between Member States, be incompatible with the common markets."

[22] Commission Notice, OJ C 384 (Commission Notice), Dec. 10, 1998, pp. 3-9, para. 9.

[23] This nondiscriminatory characterization seems to be upheld by E. Sanz Gadea, "Problemas actuales del Impuesto de Sociedades en el contexto internacional," 20 *Jurisprudencia Tributaria Aranzadi* 2003, p. 10.

[24] Commission notice, para. 14.

[25] ECJ judgment, Nov. 8, 2001, case C-143/99, *Adria-Wien Pìpeline and Others*, [2001] ECR I-8365, at 49-54.

[26] *See, e.g.,* decision of February 17, 2003, *Dutch International Financing Activities*, OJ L 180, July 18, 2003, para. 84; and decision of December 11, 2002, *Tax System in the Azores*, OJ L 17, Jan. 22, 2003, p. 20.

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the case with measures that apply only to multinational or large companies."[27]

An example of this last approach, although the reasoning is not yet public, may be found in the commission's warning to the Spanish government concerning a tax incentive addressed to export companies on the grounds of investments made abroad.[28] The commission obviously found that tax incentive to be a selective tax measure. Despite the apparent obstacles to reach a selectivity characterization of article 12(5) CTA, it could be argued that the commission may be expected to be consistent with its past approach in its review of article 12(5) CTA, which represents a similar scheme also aimed at favoring foreign investments.

Effect on Trade and Competition

In the *Iberdrola/Scottish Power* case, the commission concluded that the resulting financial strengthening of the company (due to the advantage provided by the tax allowance) would not lead to a threat to effective competition on energy markets of the EC member states involved. However, the commission reached that conclusion taking into account, *inter alia*, that the relative market position of the parties in the energy market did not raise concerns and reached that conclusion under its merger control authority. The commission left the door open to say that this measure may affect trade and competition in other circumstances.

Article 12(5) CTA departs from the general rules to determine the tax base in Spain, since it triggers a tax adjustment that does not have to be reflected in annual accounts.

According to the commission notice,[29] the mere fact that aid strengthens a firm's position compared with that of competing firms within the Community is enough to conclude that intra-Community trade is affected. The commission has thus adopted a broad interpretation on the existence of effects on intra-Community trade. This approach can be illustrated by the fact that the following circumstances were not deemed sufficient to rule out the existence of effects on intra-Community trade: the aid is relatively small,[30] the recipient is moderate in size or its share of the Community market is very small,[31] or the recipient does not carry out exports or exports virtually all its production outside the Community.[32]

While the existence of a competitive advantage may be easily inferred from the amounts referred to earlier, it may be argued that this advantage is not related to the business activity carried out in the market, since the acquisition of shares is not exactly a market as such. However, the commission would be reluctant to accept this argument given that other competing firms may claim that (i) it directly implies an advantage in the financial bidding market for the benefited companies and (ii) that it will indirectly favor the resulting position of the undertakings that benefit from the tax break in their business activity, which may in many cases be the same as the losing bidders.

Is the Measure Justified?

Article 12(5) CTA departs from the general rules to determine the tax base in Spain, since it triggers a tax adjustment that does not have to be reflected in annual accounts. Also, in contrast with mergers as defined by the CTA, the tax deduction of the financial goodwill is available in cases in which the acquirer does not obtain sole control of the foreign target company.

However, the differential nature of a measure does not necessarily mean that it must be regarded as state aid. The presence of aid may be ruled out when the measure is justified by the "nature or general scheme of the tax system."[33]

In line with the ECJ's case law, the commission has continued to take the view that this justification must be based on the intrinsic features of the system concerned. It is for the EC member state concerned to show how a derogation is justified by the nature and general scheme of the system.[34] However, only in a few cases has the commission found that a materially selective measure was justified by the general scheme of the system.

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[27] Report on the Implementation of the Commission Notice on the Application of the State Aid Rules to Measures Related to Direct Business Taxation, C(2004) 434, Feb. 9, 2004, p. 9, *available at* http://ec.europa.eu/comm/competition/state_aid/others/business/rappor taidesfiscales_en.pdf.

[28] *Supra* note 3.

[29] Commission notice, para. 11.

[30] With the exception, however, of aid meeting the tests of the de minimis rule. *See* the commission notice published in OJ C 68, Mar. 6, 1996, p. 9. Given the potential amounts mentioned above, it is unlikely that the aid may qualify as de minimis.

[31] ECJ judgment, Sept. 14, 1994, Joined Cases C-278/92, C-279/92, and C-280/92, *Spain v. Commission*, [1994] ECR I-4103.

[32] *See, e.g.,* ECJ judgments in case 102/87, *France v. Commission*, [1998] ECR 4067, and case C-142/87, *Belgium v. Commission*, [1990] ECR I-959.

[33] Commission notice, para. 15.

[34] *See* conclusions of Advocate General Léger, June 12, 2003, in case C-159/01, *Netherlands v. Commission*, para. 65.

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In that regard, the commission has accepted that a measure may be justified by the principle of tax neutrality.[35] Nevertheless, it might be difficult to argue that article 12(5) CTA enshrines the principle of tax neutrality given that this tax concession only addresses acquisitions of shares in nonresident companies that may not be available to similar domestic transactions.

At this point, although the commission has recognized that international transactions may entail specific risks that could justify derogation,[36] the eligibility criteria set by the measure must fit with the rationale of the system. It is likely that the Spanish authorities confronted with a charge of illegality of the tax measure may go along this last route to defend their case, but it is prima facie doubtful to see why companies carrying out foreign takeovers are more exposed to risks than companies carrying out domestic takeovers that do not constitute a merger. As the Court of First Instance (CFI) stressed in a case related to a regional tax scheme in Spain,[37] the fact that exceptional tax measures "operate according to objective criteria and conditions does not prove that restricting the circle of beneficiaries of the tax concession is justified by the internal logic of the tax system" concerned.

Conclusion

It is not clear whether article 12(5) CTA qualifies as state aid. The commission will likely face great difficulties concerning the selectivity criterion when assessing the case. Nevertheless, the code of conduct for business taxation agreed to by the EC member states lists as a criterion of harmful tax measures the existence of an advantage "accorded only in respect of transactions carried out with nonresidents."[38] Although the Code is a soft law and the classification of a tax measure as harmful does not imply that it will be regarded as state aid, it may give a "very clear political indication" to the commission to assess its case.[39]

What seems clear is that none of the compatibility grounds provided by the EC Treaty for measures defined as state aids would apply in this case.[40] Therefore, in the event the commission reached the conclusion that article 12(5) CTA is state aid, it would be declared illegal under the EC Treaty and two main consequences would arise: (i) the tax incentive would have to be eliminated; and (ii) recovery of the aid granted to the Spanish companies that benefited from it would be compulsory.[41]

That last scenario would be unpopular among the Spanish business community and might have an impact on the current wave of successful takeover bids launched by Spanish multinational companies. If the commission took a strong stance on the issue, the Spanish government's position still remains to be seen, since it is widely known that the current government is not satisfied with some tax perks granted by the previous government.

In any event, since none of the other member states in the EC provides for the depreciation of the financial goodwill, an infringement decision would offer an interesting precedent regarding the commission's power to shape EC member states' tax policy. ◆

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[35]Commission decision of June 5, 2002, tax exemptions and subsidized loans to public utilities with a majority public capital holding, OJ L 77, Mar. 24, 2003, p. 21.

[36]Commission decision of Feb. 17, 2003, Netherlands — Aid for international financing activities, OJ L 180, July 18, 2003, p. 52.

[37]CFI judgment of Oct. 23, 2002, Joined Cases T-346/99, T-347/99, and T-348/99, *Álava*, [2002] ECR-II4259, at 58-63.

[38]Code of conduct for business taxation, conclusions of the EU Council of Economic and Finance Ministers, Dec. 1, 1997, para. B, *available at* http://ec.europa.eu/taxation_customs/resources/documents/COC_EN.pdf.

(Footnote continued in next column.)

[39]Francesco Nanetti and Giovanni Mameli, "The Creeping Normative Role of the EC Commission in the Twin-Track Struggle Against State Aids and Harmful Tax Competition," 4 *EC Tax Review* (2002), p. 187.

[40]According to article 87(1) EC Treaty, aid measures that satisfy all the criteria outlined above are, in principle, incompatible with the common market. However, the principle of incompatibility does not amount to a full-scale prohibition. Articles 87(2) and 87(3) EC Treaty specify a number of cases in which state aid could be considered acceptable. None of them would apply to the analyzed tax incentive.

[41]In the case of state aid in the form of tax measures, the amount to be recovered "is calculated on the basis of a comparison between the tax actually paid and the amount that should have been paid if the generally applicable rule had been applied. Interest is added to this basic amount. The interest rate to be applied is equivalent to the reference rate used to calculate the grant equivalent of regional aid." Commission notice, para. 35.

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