Changes in the deduction of finance costs for corporate income tax purposes

Tax Alert

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The rules applicable to the deduction of finance costs are amended for tax periods starting on or after of 1 January 2024 as a result of an amendment to corporate income tax introduced by Law 13/2023.

25 May 2023 saw the publication in the Official State Gazette of Law 13/2023 of 24 May 2023, which amends General Taxation Law 58/2003 of 17 December 2003 with a view to transposing Council Directive (EU) 2021/514 of 22 March 2021 amending Directive 2011/16/EU on administrative cooperation in the field of taxation, and other tax laws ("Law 13/2023"). The Law entered into force on 26 May 2023.

The initial aim of Law 13/2023 was to transpose into Spanish law the set of rules governing the exchange of information of digital platform operators (which were derived from the Directive known as *"DAC 7")*.

However, over the course of its passage through the Lower and Upper Houses of the Spanish Parliament, Law 13/2023 has seen the inclusion of a number of other tax-related changes. One of these is an amendment to the rules governing the deduction of finance costs for corporate income tax purposes (article 16 of Corporate Income Tax Law 27/2014 of 27 November 2014, hereinafter, the "CIT Law"), which may prove particularly important for certain taxpayers.

Background and reasons for the amendment

Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market, more commonly known as the "ATAD" or "anti-abuse" Directive, introduced the following anti-avoidance measures:

- A limit on the deductibility of interest;
- An exit tax;
- A general anti-abuse rule ("GAAR");
- Harmonised international tax transparency ("CFC rules" or the rules on controlled foreign companies); and finally,
- A hybrid mismatches rule.

Many of these measures, which, generally speaking, were to be transposed and applied as of 1 January 2019 were already in place in Spain.

Nonetheless, in the case of the **limitation on the deductibility of interest** for corporate income tax purposes, the Directive provided that Member States whose domestic legislation was *"equally effective"* to that set out in the Directive could postpone implementation of the harmonised rule until **1 January 2024**.

Accordingly, since the rule in force both in Spain in general and in the autonomous region of Navarra, was deemed by the European Commission to be "equally effective" to that set out in the Directive (the "interest limitation" rule), its transposition has been postponed until now.

The key difference between Article 16 of the CIT Law, as worded prior to Law 13/2023, and Article 4 of the ATAD lay in the concept of **operating profit** (EBITDA) on the basis of which the 30% limit on deductible expenses is calculated.

It was thus necessary to bring Spanish legislation fully into line with the Directive in order to meet the established deadlines.

In the case of the provinces of Vizcaya, Guipúzcoa and Álava, the concept of operating profit had been aligned with the Directive since the introduction of the rule limiting the deductibility of finance costs, applicable to tax periods starting on or after 1 January 2018.

Amendments introduced

We describe below the changes introduced to the wording of the rule governing the general limitation on the deductibility of finance costs provided for in article 16 of the LIS with the approval of Law 13/2023.

- **Wording in force prior to Law 13/2023:**

The wording in force prior to the amendment introduced by Law 13/2023 essentially provided for the deductibility of net finance costs up to a limit of 30% of **operating profit** for the year (subject to a maximum of one million Euros). For such purposes, operating profit was to be calculated as explained below.

Taking as the starting point the results from operating activities per the income statement for the year "*determined in accordance with the Commercial Code and other implementing accounting regulations*", taxpayers were to:

(i) eliminate amortisation and depreciation, the attribution of non-financial and other capital grants, and impairment and income from the sale of fixed assets; and

(ii) add finance income from holdings in equity instruments, provided these correspond to dividends or shares in the profit of entities in which the stake held, be it directly or indirectly, is at least five percent (except where such a stake has been acquired using debt with respect to which the finance costs are not deductible per article 15.1.h) of the CIT Law).

However, given its relevance to the amendments introduced, it is worth noting that article 16.6 of the CIT Law also provided that the above limitation did not apply:

(i) To credit and insurance institutions, which are treated in the same way as the mortgage securitisation funds regulated in Law 19/1992 of 7 July 1992 and the asset securitisation funds referred to in additional provision five.2 of Law 3/1994 of 14 April 1994.

(ii) In the tax period in which the entity is wound up, except where this is the result of a restructuring operation.

- **Changes introduced with Law 13/2023:**

With a view to aligning the wording of article 16 of the CIT Law with the ATAD, Law 13/2023 amends it as follows:

(i) First of all, the description of how operating profit is to be calculated is amended to specify that it shall not include "*income, expenses or rent* ***not included*** *in the corporate income tax base*".

Thus, operating profit is to be calculated excluding all kinds of exempt income such as dividends, capital gains or losses deriving from transfers of shares and income from permanent establishments abroad (articles 21 and 22 of the CIT Law).

In light of the discussions regarding their classification, particularly worthy of mention are the 5% share management costs, which article 21.10 of the CIT Law refers to as expenses that should reduce the amount of exempt dividends.

Also excluded is the income from intangible assets eligible for a reduction referred to in article 23 of the CIT Law (the "Patent box"), and the expenses treated as non-deductible for CIT purposes and forming part of the operating profit.

(ii) The second change has a more specific impact.

The exclusion of mortgage securitisation funds and asset securitisation funds from the limitation provided for in article 16.6 is eliminated such that both types of funds are now subject to the limitation on the deductibility of finance costs.

These funds are eliminated because they are not included among the so-called "financial undertakings" eligible for this exception under the ATAD, based on the definition of "financial undertaking" provided for therein.

- **Entry into force of the new wording**

According to additional provision five of Law 13/2023, which amends article 16 of the CIT Law, the new wording will apply to tax periods commencing on or after 1 January 2024.

Review of the potential impacts of the amendment in 2024 and beyond

While the amendment may have gone largely unnoticed - partly because it was introduced by means of an amendment, added by the Upper House of the Spanish Parliament, to a Law with other core objectives in mind, and partly because the former wording remains largely untouched -, its scope may nonetheless entail major repercussions.

Consider, for example, groups in which the Spanish parents are holding companies whose results from operating activities are made up of the dividends of subsidiaries eligible for application of article 21 of the CIT Law.

In such cases, it is likely that the CIT deductible finance costs from indebtedness - excluding those referred to in article 15 g) and h) and article 15 bis of the CIT Law - will be reduced, as the amount of exempt dividends and capital gains will be excluded from the calculation of the operating profit to which the 30% deduction may be applied.

We would therefore recommend reviewing these issues in order to plan for the possible impact that these amendments may have for future years as of **January 2024**, with a view to adopting any relevant measures.

At KPMG we have a team of specialists available to assist you with any issues that may arise as a result of these changes.

Contacts

Itziar Galindo Jiménez
Partner
KPMG Abogados
Tel. 91 456 34 00
igalindo@kpmg.es

Carlos Heredia
Partner
KPMG Abogados
Tel. 93 253 29 00
cheredia@kpmg.es

Pelayo Oraa
Partner
KPMG Abogados
Tel. 91 456 34 00
poraa@kpmg.es

Isabel Fano
Partner
KPMG Abogados
Tel. 91 479 73 00
ifano@kpmg.es

KPMG offices in Spain

A Coruña
Calle de la Fama, 1
15001 A Coruña
Tel.: 981 21 82 41
Fax: 981 20 02 03

Alicante
Edificio Oficentro
Avda. Maisonnave, 19
03003 Alicante
Tel.: 965 92 07 22
Fax: 965 22 75 00

Barcelona
Torre Realia
Plaça de Europa, 41
08908 L'Hospitalet de Llobregat
Barcelona
Tel.: 932 53 29 00
Fax: 932 80 49 16

Bilbao
Torre Iberdrola
Plaza Euskadi, 5
48009 Bilbao
Tel.: 944 79 73 00
Fax: 944 15 29 67

Girona
Edifici Sèquia
Sèquia, 11
17001 Girona
Tel.: 972 22 01 20
Fax: 972 22 22 45

Las Palmas de Gran Canaria
Edificio Saphir
C/Triana, 116 – 2°
35002 Las Palmas de Gran Canaria
Tel.: 928 33 23 04
Fax: 928 31 91 92

Madrid
Torre de Cristal
Paseo de la Castellana, 259 C
28046 Madrid
Tel.: 91 456 34 00
Fax: 91 456 59 39

Málaga
Marqués de Larios, 3
29005 Málaga
Tel.: 952 61 14 60
Fax: 952 30 53 42

Oviedo
Ventura Rodríguez, 2
33004 Oviedo
Tel.: 985 27 69 28
Fax: 985 27 49 54

Palma de Mallorca
Edificio Reina Constanza
Calle de Porto Pi, 8
07015 Palma de Mallorca
Tel.: 971 72 16 01
Fax: 971 72 58 09

Pamplona
Edificio Iruña Park
Arcadio M. Larraona, 1
31008 Pamplona
Tel.: 948 17 14 08
Fax: 948 17 35 31

San Sebastián
Avenida de la Libertad, 17-19
20004 San Sebastián
Tel.: 943 42 22 50
Fax: 943 42 42 62

Seville
Avda. de la Palmera, 28
41012 Sevilla
Tel.: 954 93 46 46
Fax: 954 64 70 78

Valencia
Edificio Mapfre
Paseo de la Almeda, 35, planta 2
46023 Valencia
Tel.: 963 53 40 92
Fax: 963 51 27 29

Vigo
Arenal, 18
36201 Vigo
Tel.: 986 22 85 05
Fax: 986 43 85 65

Zaragoza
Centro Empresarial de Aragón
Avda. Gómez Laguna, 25
50009 Zaragoza
Tel.: 976 45 81 33
Fax: 976 75 48 96