

Acquiring Distressed Debt in Spain by Sonia Velasco and Iñigo de Luisa (January 2009)

When investing in distressed debt in Spain and, particularly, in nonperforming loans (NPLs), it is important to set up the structure in advance, particularly from a tax and regulatory perspective, and become familiar with Spain's Insolvency Act (Law 22/2003, July 9, Concursal).

Because of the recent boom period in Spain, there has been little case law testing the controversial issues raised under this new law. These are the most important issues to keep in mind in connection with distressed debt transactions:

- The investor needs to be aware of the type of debt being acquired, and from whom and at what stage it is being acquired. For example, if you acquire credits after the date insolvency is declared, you will not be entitled to vote for the composition agreement.
- The clawback period is the two-year period before insolvency was declared, so any action or agreement the debtor carried out during that time could be reviewed and rescinded if it is concluded that it damaged the debtor and led to the insolvency.
- The insolvent's debts are ranked as follows: (i) preferential credits (special or general); (ii) ordinary credits (nonsecured); and (iii) subordinated credits (particularly those granted to the debtor by specially related parties, such as shareholders holding at least 5 percent (for listed companies) or 10 percent (for unlisted companies)). The judge deciding the insolvency proceedings is not bound by intercreditor agreements; these agreements are considered effective between the parties that entered into them and may be enforced against any party breaching them.
- If the asset is directly related to the debtor's business activity, the enforcement of in rem security (pledges and mortgages) may be suspended for up to one year.
- Voting rights to approve the composition agreement are mainly vested in the ordinary creditors, and approval requires half of their votes. Preferential creditors do not usually vote, and subordinated creditors are not entitled to vote.
- No interest accrues from the date insolvency is declared, except interest on credits secured by in rem security (pledges and mortgages), up to the secured interest amount.

Generally, the transfer of loans or credits is formalized through an assignment public deed granted before a Spanish notary. This usually means that the foreign investment company must obtain a taxpayer identification number. Also, the debtor should be notified, although this is not required for the transfer to be valid.

This type of lending is not a restricted banking activity, so prior authorization from the Bank of Spain is not required. However, if a foreign entity exceeds specific thresholds when providing funds to a Spanish resident, it would need to obtain a financial transaction number from the Bank of Spain by filing the necessary forms.

It is important that transferors (for example, Spanish financial institutions looking at transferring distressed debt or assets) adequately structure vehicles to hold the pool of assets, particularly when dealing with real estate assets resulting from enforcement proceedings relating to such security, so they can optimize their capital ratios and balance sheet and minimize the costs of indirect taxes.

From a tax point of view, there are two main aspects that need to be taken into account:

- direct taxation on interest paid to the acquirer of the NPL; and
- indirect taxation on the purchase of the NPL.

Regarding direct taxation, income from an NPL is subject to corporate tax at the ordinary 30 percent rate if paid to a Spanish entity. If the interest is paid to a nonresident entity, the Nonresident Income Tax Act provides for an 18 percent withholding tax to be applied unless the interest is paid to an EU lender (for example, to a Luxembourg or Irish entity).

Regarding indirect taxation, the transfer of an NPL does not trigger VAT or stamp duty unless the transfer is of a mortgage security. In that case, a 1 percent stamp duty would be due on the secured amount. However, under some circumstances (for example, when the mortgage facility is transferred with only minor changes to the terms and conditions of the debt), it is possible to be exempt from stamp duty and reduce other costs involved as a result of Law 2/1994 (the subrogation of mortgage loans).

In the event it is necessary to execute the mortgage security over the secured real estate property to obtain repayment on the loan together with interest, transfer tax at a rate of 7 percent would be due over the true value of the real estate property transferred. In some situations, VAT would be due instead of transfer tax, but in that scenario, both buyer and seller should be subject to VAT and the buyer should acquire the real estate property for business purposes.

If the debt is to be converted into capital, the conversion of the debt into capital would be subject to a 1 percent capital tax, but not if the debt was converted into a profit-sharing loan.

Finally, the acquisition of a vehicle with a pool of assets could be an excellent alternative for investors because of its simplicity. However, if acquiring a controlling stake (or increasing a controlling stake) in a company whose assets are mainly Spanish real estate, the transfer would trigger a 7 percent transfer tax for the purchaser on its pro rata share of the market value of the underlying real estate assets.