

FISCAL INCENTIVES OF THE CANARY ISLANDS ECONOMIC AND FISCAL REGIME



EY
Abogados

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Introduction: Why the Canary Islands



Introduction: The Canary Islands

The Canary Islands are a Spanish archipelago located in the Atlantic Ocean next to the north-western coast of Africa.

As Autonomous Community of Spain, the Canaries are fully integrated within the European Union (EU) and the taxes applied are similar to those of mainland Spain, with the particularity that being a distant and fragmented territory, the Canary Islands have several tax incentives to promote the investment in its territory.

Taking into consideration the location, the legal system and the economic, educational and social figures of the Canary Islands, this location may be of interest for multinational Companies that would like to establish regional headquarters for their African operations and subsidiaries.

The fiscal specialties of the Canary Islands will be described in the following slides and potential tax efficient alternatives for the African operations will be outlined





The Canary Islands Investment Reserve

The Canary Islands Investment Reserve

- **Definition of the Canary Island Investment Reserve**

What is the Canary Island Investment Reserve?

The Canary Island Investment Reserve, hereinafter RIC, is a corporate income tax benefit aimed at stimulating self-financed investment which have important effects over the taxable base.

- **Scope of the Canary Islands Investment Reserve**

Who can benefit from the RIC?

Contributing to the RIC represents fiscal advantages. This special incentive is applied to the following persons or entities:

- Companies and other legal bodies subject to paying Corporation Tax in relation to their establishments in the Canary Islands.
- The RIC can also be applied by individuals and entities non resident in Spain that operate in the Canary Islands through a permanent establishment, for the income obtained, through a reduction in the taxable base of the Non Residents Income Tax.
- Individuals subject to paying Income Tax, only if their net income comes from business activities who have their fiscal domicile in the Canary Islands.

The Canary Islands Investment Reserve

• Application and calculation of the RIC

What fiscal advantages does the RIC offer?

The RIC enables a company to reduce its tax base, for Corporation Tax, by up to 90% of its undistributed Profits. This is applicable to whatever amount of profits (from economic activities) the establishments located in the Canary Islands decides to allocate to the Canary Island Investment Reserve.

The application of the RIC is exclusively limited to the benefits obtained from economic activities, that have not been distributed, being excluded, among others, benefits obtained from the transmission of fixed assets that have benefit from reinvestment deduction or benefits deriving from the transfer of fixed assets already been used to invest the RIC.

What are considered to be undistributed profits for calculating the limits of fiscal advantage?

Undistributed Profits are understood to be those that are allocated into the company's reserves. In addition to profits excluded from RIC mentioned before, it will be considered as distributed profit the Legal Reserve to be allocated, dividends to be distributed and any other equity dispose.

Furthermore, if the company disposes of its equity in the same fiscal year in which the reduction of the taxable base due to RIC allocation takes place, it is understood that the RIC allocation is reduced in the amount of the equity disposed of. The same reduction might be applied in the fiscal year in which the shareholders meeting adopt the agreement by which the RIC is allocated (that is, the fiscal year following the one in which the profit was obtained).

The Canary Islands Investment Reserve

• RIC Example

In the following table the tax payable with RIC allocation is calculated and it is compared against the tax payable obtained by a company that does not develop any activity in the Canary Islands and hence cannot apply the RIC benefit:

	RIC	General Regime
Accounting result after CIT	1.200.000€	1.200.000€
Previous taxable base	1.200.000€	1.200.000€
RIC (90% reduction in the taxable base)	1.080.000€	0€
Gross tax payable (25%)	30.000€	250.000€
RIC tax saving	220.000	0

For the purpose of this example possible adjustment to the tax base and other tax deductions, etc. have been omitted.

The 1.080.000€ allocated to the RIC must be destined to the investments allowed for this purpose.

The Canary Islands Investment Reserve

• Requisites of the RIC - Investment

What investment requisites have to be met to enjoy the fiscal benefits of the RIC?

The requisites related to the investment of the RIC that must be met to fully and effectively enjoy the fiscal benefit are as follows:

1. Deadlines for investing RIC funds.

Taxpayers have a maximum of five years to invest the RIC: the year in which the income is obtained, the year in which the reserve is recorded for accounting purposes and the following three years. Investments will be considered to be made when put into operation.

2. Minimum ownership of RIC assets.

The minimum period during which assets acquired with RIC funds must remain in operation depends on the investment option chosen:

- Investments in Fixed Assets: 5 years or the useful life of the asset in question, if this is less. In this case the asset must be replaced by other with similar characteristics. Useful life is considered to be the maximum depreciation installment listed in officially approved amortization tables.
- In case of acquisition of land, such period should be increased up to 10 years.
- Other investments: 5 years.

3. Materialize the reserve.

Sums allotted to the RIC must be invested in one of the allowed investments: (i) initial investments, (ii) ongoing investments or (iii) subscription of shares.

The Canary Islands Investment Reserve

Initial Investments

Investment	Description	Requirements
Fixed Assets	New coporal or intangible assets destined to	<ul style="list-style-type: none"> - Setting up of a new establishment for the developing of an economic activity. It will be considered as a new establishmen any initial investment that determines that such establishment is put into operation for the first time. - Enlargement of an existing establishment. It will be considered as such when the investment increases the total value of the fixed assets assigned to the establishment. - Diversification of the activity of an establishment for the manufacturing of new products, or for the purpose of obtaining a different product or service, or ones which represent an essential novelty and not merely formal or secondary, compared to the products or services that the establishment was offering prior to the investment. - Fundamental change in the production process of an existing establishment, when the new process has features or applications from a technical point of view that differ essentially from the ones existing in the establishment prior to the investment.
	Used assets	Small and Medium-sized Enterprises can invest in used assets that have not taken advantage of the RIC before, meeting the requirements of above mentioned
Land	Purchase of land	<p>Not taken previously advantage of this regime, and assigned to one of the following activities:</p> <ul style="list-style-type: none"> - Promotion of government-protected housing. - Development of industrial activities included in Divisions 1 to 4 of the first section of the tariffs of the Tax on Economic Activities. - Shopping centres and tourist assets whose acquisition has the purpose of refurbishing for its renovation.
Intellectual or Industrial property	Intangible assests	The investments can only consists in patents rights, licenses, know-how or unpatented technical knowledge), with the limit of 50% of the value of the investment, except for Small and Medium-sized Enterprises which limit will be 100%.
Job Creation	Job creation	Job creation in directly related to initials investments aforementioned in a period of six months since they have came into operation

The Canary Islands Investment Reserve

- Ongoing investments and Subscription of shares

Fixed Assets		Acquisition of fixed assets, corporal or intangible, which do not meet the requirements to be considered an initial investment.
Environment Investments	Assets that contribute to the improvement and development of the environment	Acquisition of assets that contribute to improve and protect the natural environment in the Canary territory, as well as the investments assigned to the exploitation of renewable energy sources for its transformation into electricity
R&D	Research and Development expenses	
Job Creation	Job creation	Job creation not linked with initial investment with a limit of the 50% of the RIC allocated.

Investment	Description	Requirements
Subscription of shares issued by other companies	Subscription consequence of its incorporation or a capital increase	The subsidiary must develop its activity in the Archipelago. These companies will invest the amount subscribed in the investments described above being initial investments, ongoing investments or job creation
Subscription of ZEC shares	Subscription of shares issued by entities of the Special Canary Zone (ZEC), as a consequence of their incorporation or capital increase	The amount of the capital incorporated or increased cannot be destined to the investments required for the application of the ZEC regime.
Other financial instrument	Any other financial instrument issued by financial entities	Financial instruments must be issued for the purposes of financing private projects previously accepted by Canary Government and Tax Authorities.
Public Bonds	Subscription of book-entry debt	Debt issued by the Canary Islands Autonomous Community government, or by Canary Islands local corporations or Autonomous Community government agencies with the limit of the 50% of the year RIC allocations

The Canary Islands Investment Reserve

• Compatibility between the RIC and other fiscal instruments

Are RIC tax benefits compatible with other fiscal incentives?

The RIC is **compatible** with fiscal benefits deriving from specific incentives of the Canary Islands Economic and Fiscal Regime and the General Corporation Tax Regime:

- Tax Allowance for Producing Tangible Goods.
- Estate Tax and Stamp Duties exemptions for acquiring assets.
- Special Regime of Deductions for Investments in the Canaries, but in the physical sense, ie the same amount of a concrete investment cannot be destined to RIC and deduction at the same time but different amounts of a concrete investment can be used for different tax benefits (RIC vs deduction).

• Penalties for failing to meet requirements

What happens if the above requirements are not met?

Failing to comply with any of the requirements to benefit from the regime implies the obligatory regularization of the RIC. This will be made by increasing the tax base of the fiscal year in which a requirement is not observed in the amount of the RIC allocated (or increasing the tax payable in the Personal Income Tax), plus late payment interests and, if it is the case, penalties that were of application.



Allowance for the production of tangible goods in the Canary Islands

Allowance for producing tangible goods in the Canary Islands

- **Definition of the allowance for producing tangible goods in the Canary Islands**

What is the allowance for producing tangible goods in the Canary Islands?

It is a tax incentive that reduces the amount payable in Corporation Tax. The aim of this fiscal instrument is to promote manufacturing activity in the Canary Islands.

Taxpayers will have the right to apply a reduction in a 50% of the portion of gross tax payable derived from income obtained in the sale of tangible goods specific to agricultural, livestock farming, industrial or fishing activities, provided that they have been produced by the taxpayer within the Canary Islands.

This reduction applies to companies, individuals, permanent establishments or branches -regardless where the company has its registered offices-, that work directly in the production of tangible goods in the Canary Islands.

Allowance for producing tangible goods in the Canary Islands

• Application of the tangible goods production allowance

What is the tax benefit involved in the production allowance?

Reduction in a 50% of the portion of gross tax payable derived from income obtained in the sale of tangible goods specific to agricultural, livestock farming, industrial or fishing activities, provided that they have been produced by the taxpayer within the Canary Islands.

Allowance = 50% x 25% (corporate income tax general rate applicable from FY2016 onwards) x Proportion of sales of tangible goods produced in the Canary Islands from the total sales.

• Compatibility between production allowance and other fiscal instruments

Can a company benefit from the RIC and the other fiscal advantages of the REF at the same time?

This instrument is compatible with other fiscal incentives. In particular, any company that benefits from the Tangible Goods Production Allowance is also eligible for the fiscal advantages arising from The Canary Island Investment Reserve or the Estate Tax and Stamp Duty exemptions.



The Deduction for Investments in Canaries for new fixed assets and the increased corporate income tax deductions in the Canary Islands

Corporation Tax Deduction for Investments in the Canary Islands for new fixed assets.

. Tax Credit for investment in new fixed assets

What is the Deduction Regime for Investments in new fixed assets?

It is a fiscal incentive applicable in the acquisition of new fixed assets in the Canary Islands. The amount of the deduction is calculated by applying the legally stipulated percentage deduction (25%) to the acquisition cost of the asset. The deduction, calculated as said, will reduce the corporate income tax quote after applying the deductions for double taxation and possible allowances.

Who is eligible for deductions for investments in the Canary Islands?

The special deduction regime for investments in the Canary Islands is applicable to the following persons:

- All companies and other legal entities that pay Corporate Income Tax or non-resident income tax provided that:
 - They are domiciled in Canaries.
 - Or, if not, that they maintain at least one permanent establishment in the Islands.
- Individuals, who engage in business or professional activities in the Canary Islands.

Corporation Tax Deduction for Investments in the Canary Islands for new fixed assets.

• Application of the special deductions regime for investments in the Canary Islands

What deduction rates are applicable to investments in the Canary Islands?

1. The Canary Island especial deduction tax regime allows for a tax credit of 25% of the acquisition cost of new fixed asset. However, the deduction applied may not exceed of 50% of the corporate tax quote.
2. The fixed assets must be linked to the economic activity developed in the Canary Islands and maintained in use for 5 years or its useful life, if it was lower.
3. For these purposes, land it not considered a new fixed asset. Also buildings financed by leasing financial contracts are also excluded.
4. The deduction for investment in the Canary Islands regime can also be applied to used fixed assets, provided that:
 - They have not previously benefited from the investment deduction.
 - They belong to one of the following categories: i) machinery, installations and utilities, ii) equipment for information processing, y iii) elements of interior or exterior transport excluding those vehicles used by persons directly or indirectly associated with the company.
 - They represent a technological improvement for the company.

The increased corporate income tax deductions in the Canary Islands

- **Application of the increased deductions regime for investments in the Canary Islands**

What is the increased Regime for Investments in Canary Islands?

Increased tax credits rates for investments made in the Canary Islands, with respect to those applicable to investments in the Spanish mainland.

What investment rates are applicable to investments in the Canary Islands?

This tax benefit consist of a reduction in the corporate tax quote, once the double taxation deduction and other possible allowances have been applied. The legally stipulated percentage deduction for each category of investment applicable in the rest of the Spanish territory will be increased for the Canary Islands. The following investments categories are eligible for deduction:

- Films producer investments.
- Investment for R&D&i activities.

In this sense, the tax credit rates applicable in the Canary Islands are increased an 80% over the ones applied in the general regime, with a minimum difference of 20 percentage points. Likewise, the limits for the offsetting of the tax credit against the tax quote are also increased.

Corporation Tax Deduction for Investments in the Canary Islands for new fixed assets.

- **Compatibility between the special Canary Island Investment deduction regime and other fiscal incentives**

Can a company be eligible for other fiscal advantages at the same time?

Entities that are eligible for the special Canary Island investment deduction regime can also enjoy the following fiscal advantages at the same time:

- Estate Tax and Stamp Duty exemption on acquired assets (with restrictions).
- Allowance for Producing Tangible Goods.
- Reserve for investment in the Canaries, although in the physical sense referred to above.

Increased Canary Islands tax credits rates with respect Spain mainland:

	Canary Islands Regime	General Regime
Film production (international films)	35%	15%
Film production (national films)	38%-40%	18%-20%
R&D (standard rate)	45%	25%
Innovation	45%	25%



The ZEC regime

The ZEC regime

• General requirements

Who can benefit from the Special ZEC Regime

The special ZEC regime may be applicable to newly incorporated legal persons as well as branch offices (new), which meet the following requirements:

- The entities should have their corporate seat and their effective place of management within the geographical limits of ZEC. In that sense, the geographical limits of the ZEC is considered to be the whole territory of Canary Islands.
- At least one of the member of the board of administrators should be resident in the Canary Islands. For branch offices, this requirement will be fulfilled with a legal representative.
- Their corporate purpose should be included in the list of permitted activities.
- Perform investments in tangible and intangible assets within the first two years following the registration in the ZEC Registry. Such assets should be located or received within the geographical limits of the ZEC and should be used within such limits and necessary for the business activity carried out by the ZEC entity. In Gran Canaria and Tenerife (main islands of the archipelago) such investments should amount to 100,000 euro. In the rest of the islands the amount is reduced to 50,000 euro.
- Create and maintain a minimum number of 5 jobs within the geographical limits of the ZEC in the case the company is located in Gran Canaria or Tenerife. In other islands the job creation and maintenance is reduced to a minimum of 3 jobs.
- File before the ZEC Committee a descriptive report of the business activities to develop.

The ZEC regime

. Tax treatment

What are the implications of being subject to the Special ZEC regime as regards to the Spanish Corporate Tax return?

Spanish Corporate Income Tax:

The entities subject to the ZEC special tax regime will be subject to the Spanish Corporate Income Tax (CIT) with the following particular features:

- ▶ In principle, the tax rate applicable to these entities should be **4%** (25% is the general tax rate of Spanish CIT applicable from FY2016 onwards)
- ▶ This reduced tax rate should be applicable to taxable income linked to the transactions effectively performed within the geographical area of the ZEC, which it is determined applying the following rules:
 - ▶ The taxable base should be determine following the provisions stated in the Spanish CIT Act.
 - ▶ This taxable base will be distinguished in two parts: the one which will be taxed at 4% (hereinafter, “ZEC tax base”), and the one to which will be applied the general tax rate. In this regard, the “ZEC tax base” will be the lower of the following amounts:
 - ▶ The amount corresponding to the transactions carried out materially and effectively within the geographical area of the ZEC, which calculation will be obtained through the application of the below mentioned fraction.
 - ▶ The amount derived from the application of the chart related to the limitation of the taxable base

The ZEC regime

► Tax treatment (Cont.)

1.- Fraction which determines the taxable base understood materially and effectively generated in the geographical area of the ZEC. The percentage will be round to the superior unit.

- + Transfers of movable goods carried out within the geographical limits of the ZEC
- + Transfers of immovable properties located within the geographical limits of the ZEC
- + Rendering of services performed through means assigned to the ZEC entity
- + Transactions delivered to branches located outside of the ZEC
- Transactions received from branches located outside of the ZEC
- Transfer of assets acquired by the ZEC entity from other non ZEC entities as a result of transactions performed under the Spanish tax roll-over relief regime

ALL TRANSACTIONS CARRIED OUT BY THE ZEC ENTITY

2.- Chart with the restrictions to the taxable base (new):

	Limit "ZEC taxable base"	Employments	General Limit
Gran Canaria and Tenerife	€1.800.000	5	The reduction in the net tax liability as a consequence of the application of the tax rate 4% won't be able to be higher than 17,5% of the net revenues obtained by ZEC entity if it is considered part of the industrial sector (or 10% for other sectors).
	Additionally to the abovementioned figure, €500.000 for each employment created (maximum €24.300.000)	6 - 50	
	Ilimited taxable base	More than 50	
Rest of the Islands	€1.800.000	3	
	Additionally to the abovementioned figure, €500.000 for each employment created (maximum €25.300.000)	4 - 50	
	Ilimited taxable base	More than 50	

The ZEC regime

• Other tax benefits

How would affect to the other taxes of application?

Spanish Non Resident Income Tax (NRIT):

- Interest payments performed by ZEC entities to non resident taxpayers should not be subject to withholding tax (WHT) in Spain as long as such interest income is not obtained through a black listed jurisdiction for Spanish tax purposes
- Dividend payments performed by ZEC entities to their parent entities, even if such parent entities are not residents in EU member States, should not be subject to WHT if certain requirements are met.

Transfer Tax, Capital Duty and Stamp Duty:

- The acquisition of rights and goods should not trigger transfer tax, as long as, the taxpayer assigns them to its business activity and when such goods and rights are located or can be executed within the geographical limits of the ZEC
- Only the dissolution of ZEC entities should trigger capital duty at 1% rate over the fair market value of the goods and rights received by the shareholders
- No stamp duty should be levied, although with some exceptions

The ZEC regime

• Other tax benefits (II)

How would affect to the other taxes of application?

IGIC (Canarian VAT):

- The supply of goods and the provision of services performed by ZEC entities to other ZEC entities should be exempt from IGIC
- The importation of goods carried out by ZEC entities should be exempt from IGIC
- The aforementioned exemptions should not affect the ability of deducting other input IGIC by the ZEC entities

EU Directives and Double Tax Treaties:

- The ZEC entities are entitled to apply all the double tax treaties (DTT) concluded by Spain and all the EU Directives (i.e., Parent-Subsidiary Directive, Interest & Royalties Directive, etc.)

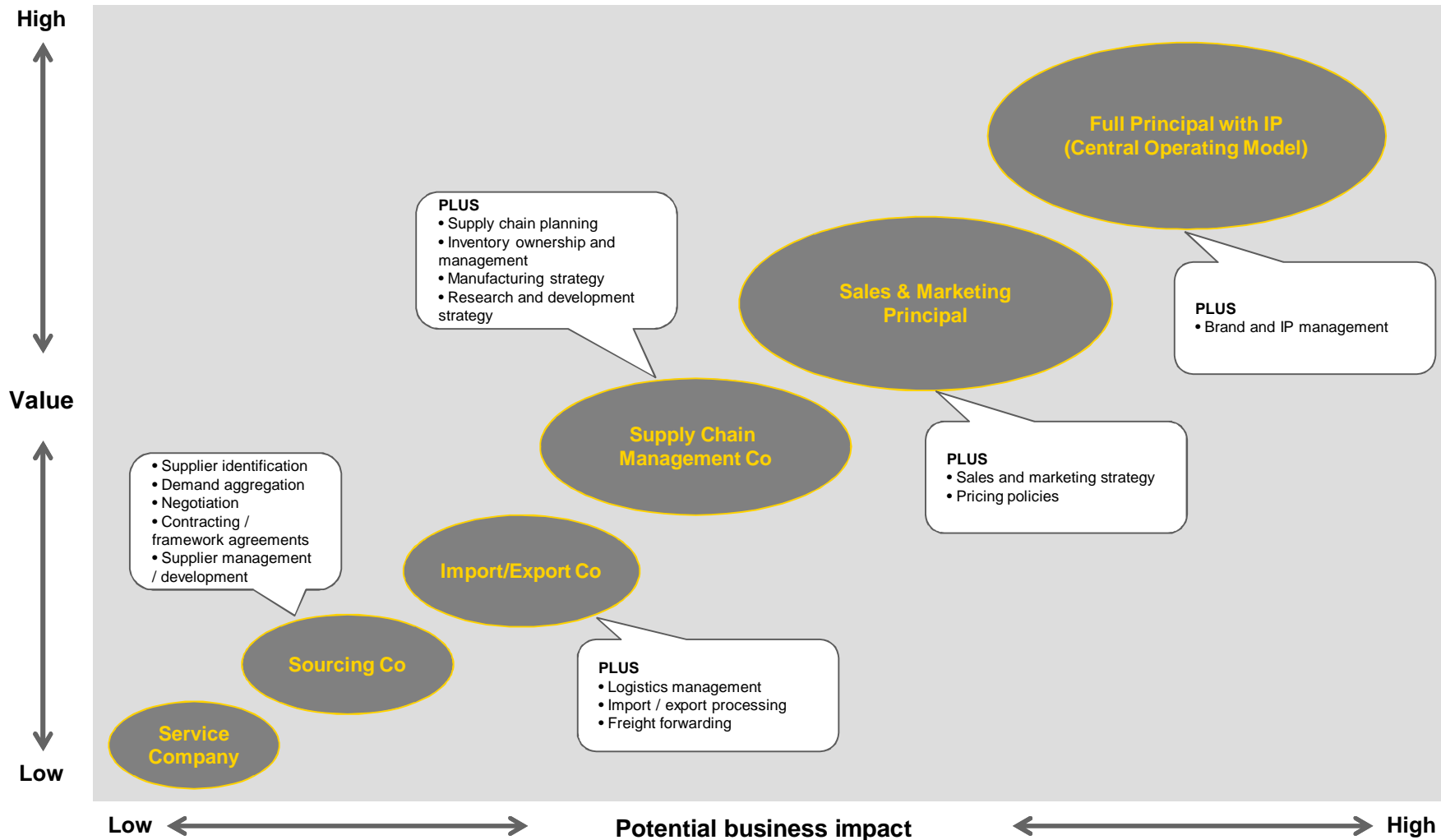
Best practices in the ZEC regime

- ✓ Canadian multinational company of the mining industry has established its African HQ in the Canary Islands
- ✓ Various hotel companies have set up its reservations department in the Canary Islands
- ✓ US telecom multinational based in Miami, with presence in 80 countries all over the World and in 3 African countries has established its African HQ in the Canary Islands
- ✓ German multinational company world market leader in the large diesel engines for use in ships and power stations being one of the three world leading suppliers of turbo machines, has established a service company for operations in the Atlantic Ocean area
- ✓ Italian multinational company focused on the manufacturing of building components, has set up a ZEC company for selling operations in Africa
- ✓ German company market leader in nails and cosmetics has set up a service company, including trading operations and logistics
- ✓ German multinational company wholesaler of components has set up a company for whole-selling operations in the African market
- ✓ Swiss multinational in the oil business has set up a logistic center between Africa and Europe placing the Canary Islands in the bunkering services map
- ✓ Norwegian R&D company has set up an R&D center to develop marine wave energy.
- ✓ U.S. pharmaceutical has set up its manufacturing and logistics facilities for Africa
- ✓ U.S. portable renewable energy tower systems company has set up an African logistics company
- ✓ European leading IT services company has set up a subsidiary focusing in African operations

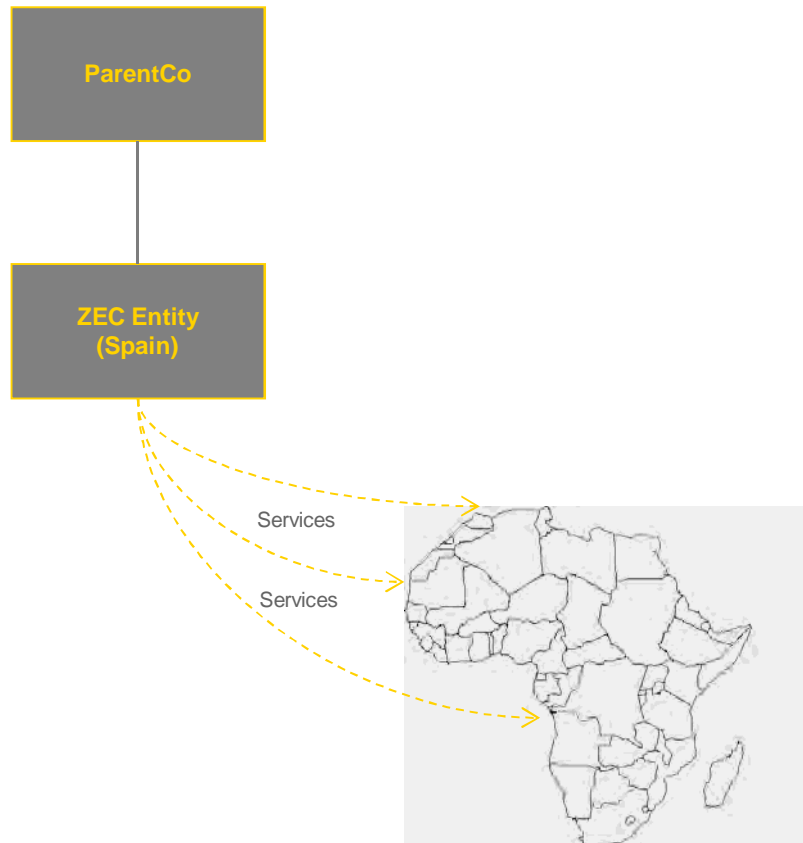


Potential tax planning solutions

Degrees of centralization: The more centralization, the greater the business and tax benefits could be



Solution 1: Regional share-service center / principal



Description

- The ZEC entity may be envisaged as a share-service center/principal for multinational groups in relation to their African operations
- Depending on the level of centralization of functions the level of tax benefits (i.e., tax savings) may vary

Main tax advantages

- The income allocated as a result of the functions centralized should be subject at 4% CIT rate taking into consideration the limits and requirements already outlined
- No WHT on dividend payments should be triggered if certain requirements are met. In order to get full advantage of the ZEC regime it would be advisable to locate the ZEC entity underneath a ParentCo tax resident in a jurisdiction with a Participation Exemption regime
- No WHT on interest payment should be triggered if certain requirements are met
- Spain has concluded DTTs with Tunisia, Algeria, Morocco, Egypt and South Africa. In addition some new DTTs are pending of being finally concluded
- The ZEC entity may also qualify as an ETVE (Spanish holding company regime) meaning that foreign dividends should not be taxed to ParentCo if certain requirements are met



Reduced Indirect Taxation

The ZEC regime

• Other tax obligations

IGIC

Indirect General Tax of the Canary Islands:

- IGIC is a general indirect tax levied on goods delivered and services rendered carried out by businessmen and professionals, as well as the goods imports developed within the Canary Islands zone.
- Is similar to the EU VAT, at the standard rate of 7%.

AIEM

Tariff on Islands Goods Import Duties:

- Application of the Tax on Imports on the production and import in the Canary Islands of certain tangible goods.
- Tin general the AIEM imply a higher cost on the buying prices since a deduction on the tax quotas supported by the taxpayer is not allowed. However, the quotas must be refunded in some cases.



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