

SPANISH PROPERTY OWNERSHIP THE NEW 5% TAX Jonathan Miller¹

Background

Real property in Spain is often owned via the medium of a third-party structure. Commonly that structure is simply a company incorporated in an offshore jurisdiction. (Andorra, Gibraltar, Isle of Man, Jersey, Guernsey, BVI, Panama, inter alia, all get regular star billing in this regard). Frequently the shareholder of that company is a trust (and sometimes an anstalt or a stiftung). The trust may be discretionary, or in some circumstances with interest-in-possession, often for the settlor. Sometimes the trust owns the real property directly without an intervening company. On occasion, the structure is more complex, and from time to time quite baroque.

Some structures result from the DIY enthusiasms of the owner; some arise from the commercial activities of offshore company incorporators and managers, in which the standard of ethical care for the result can range from the non-existent to the rarer excellent; and some from the planning work done by the professions. Many are "inherited" by purchase from previous owners in transactions which focused on the underlying property, the surrounding structure usually having received scant attention.

Whatever the details of the structure, it is rare that there is not an ultimate beneficial owner who regards himself as the real, de facto, if not de jure owner. Certainly he uses the underlying property as if it were directly his own. It is also true to say that much of the professional work in this field is remedial, and to do with untangling the effects of the structure once the eyes of the Spanish authorities - normally Hacienda² - are drawn to it.

The objectives and motives of the beneficial owners in employing such structures are as various as the owners themselves. Most commonly, upon examination, the motive appears to have been that it seemed to be a good idea, and that it probably

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² Hacienda - the Spanish equivalent of the UK's Inland Revenue.

saves taxes. Whether either of those is valid will depend (as readers of this review will doubtless be bored with saying) upon the totality of the circumstances of the individual case.

Aim of this article

The purpose of this article is to review briefly what may have been the objectives of the beneficial owners or their advisors in employing such structures; to comment on the likely success or otherwise of those; to rehearse the details of the new Impuesto Especial (the 5% tax); and to consider its effects upon planning, for both existing and proposed new structures.

Why use an offshore structure?

There is normally no single rationale; the decision to use a third-party structure may have considered some or all of the following:-

- *Avoid the Spanish equivalent of capital gains tax³ on the alienation of real property on a resale or gift.
- *Avoid the costs, on a resale or gift, of conveyance of real property, and the associated transfer tax (ITP)⁴, which together can add up to as much as 9% - 11% of the value of the property⁵.
- *Simplicity of transfer on a resale or gift (stock transfer form versus legal conveyance of real property).

³ For residents, the gain is normally sliced over the number of years of ownership, the slice added to income in the year of disposal, and the resulting marginal tax-rate applied to the whole gain. For non-residents, the gain is charged at a flat 35%.

⁴ ITP - Impuesto sobre Transmisiones Patrimoniales y Actos Juridicos Documentados; several rates, but generally 6% on transmission of residential property.

⁵ Normally the costs are the liability of the purchaser, or passed by a contract term to him. This cost nevertheless has an impact on the vendor, if only on the price an alert purchaser is prepared to pay.

*Avoid the often under-considered "plus valia"⁶, which is a municipally-collected tax, charged on the increase in the *catastral*⁷ value of the land underlying the property, when there is a change of title to the land⁸. Strictly this tax is not avoided since a non-resident property owner can be charged "plus valia" every ten years, although some municipalities can be forgetful in this regard.

*Avoid ISD⁹ (Spain's equivalent of Inheritance Tax). Strictly this is not effective for beneficiaries resident in Spain.

*Avoid the rules of *legitima*¹⁰ (forced heirship) in which testamentary freedom is severely limited, even for those of non-Spanish domicile when disposing of Spanish-sited immoveable property.

*Achieve or maintain confidentiality of ownership (for the multitude of reasons for which confidentiality may be sought).

⁶ "plus valia" - Impuesto sobre el Incremento de Valor de los Terrenos de Naturaleza Urbana. The actual amount of tax is calculated from a matrix based upon the population size of the municipality, and number of years since the last charge to plus valia. This latter is, incidentally, one of the horrific dangers of buying land or property to which the vendor has title only by private contract rather than *escritura publica* since the former will not have been reported for taxes, and the purchaser could be acquiring a large historical liability.

⁷ *catastral value* - *valor catastral*. Broadly equivalent to a sort of "rateable value". Each piece of land or property has such a value which can be ascertained from the local town-hall, and is used as the basis for a number of taxes on property. Historically, *catastral* values have seemed not to exceed 60%-70% of market value, but recent increases in *catastral* values combined with soggy market prices have generally eroded the differential.

⁸ The plus valia is strictly the liability of the vendor, although normally passed by a contract term to the purchaser.

⁹ ISD - Impuesto sobre Sucesiones y Donaciones. Charges gifts *inter vivos* and *mortis causa* upon the recipient. Spouses are not exempt beneficiaries. Maximum rate is 34%, but then multiplied by a co-efficient from 1 to 2.4 (depending in part upon degree of kinship between taxpayer and donor) thereby producing a maximum marginal-rate charge of 81.6%. Residents are charged on world-wide receipts, and non-residents on Spanish-sited receipts.

¹⁰ May be found in the *Codigo Civil* (Civil Code) at Book 3, Title 3, Chapter 2, Section 5 (Arts 806-822).

*The ability (now of almost historic virtue) to transact a sale of the property - that is to say, of the shares of the company - outside Spain's exchange controls.

*Avoid a declaration for IP¹¹ (Wealth Tax).

*Property developers have found uses for offshore structures. For example:-

- to build a land bank without alerting neighbouring potential vendors to the possibility of price escalation, by using different companies to acquire individual land-plots.
- to take development gains outside Spain.

What problems may there be?

Setting on one side for the moment the additional considerations introduced by the new 5% tax, it is instructive to consider the general areas in which problems may arise.

There is no doubt that a properly-established structure, based in detailed consideration of its effects, remains a valuable planning tool in appropriate cases. Most of the problems mentioned below exist due to the "panacea syndrome" (in which it is popularly believed that an offshore company causes all problems of title, tax liability, and personal visibility to disappear in a puff of mysterious smoke), and the blunderbuss approach to distribution and administration of the medicine.

It would be inappropriate to attempt here a full review of the potential problems. This article confines itself to a few dips into the bran-tub to give a flavour.

***Occupation/use of the property.**

It is around this matter that the largest crop of issues arise. For whatever reason, the beneficial owner has deliberately divorced himself from overt ownership of the property. In the worst case, he then completes the circle by taking up physical residence in it. In other cases he uses it for holidays, or lets it himself, or causes it to be let by the owning company. Rights to occupation or use of real property command close protection, and hence attention, from the Spanish law; such rights or uses attract taxation when provided by one person to another. To illustrate the point, the following example may serve.

A Manx company, XYZ Ltd, owns as its sole asset Casa Supadupa situated in Marbella. XYZ has no other activities. The shares of XYZ are held by nominees to the order of Mr and Mrs Smith. The directors of XYZ are also nominees, resident in Monaco. The Smiths live in Casa Supadupa for approximately nine months of the year, spending the other three months

¹¹ IP - Impuesto sobre el Patrimonio. An annual tax on an individual's wealth (world-wide for residents; Spanish-sited for non-residents) which in general is monetarily insignificant, but which acts as a remarkably effective control for capital and income taxes.

visiting relatives in the UK and taking holidays outside Spain.

ISS¹² Art 4(1)(b) makes liable to tax by way of "obligación real" those non-resident entities with sources of income or gains sited in Spain, or which receive income paid by any person or entity resident in Spain. ISS Art 3 treats as income for the purposes of the tax income derived, inter alia, from any asset of the company. ISS Art 7(c) and RIS¹³ Art 19(c) define as arising in Spain any income derived from real property situated in Spanish territory, or rights to the use or enjoyment thereof. RIS Art 5(b) and Art 9 treat as income any benefit of any nature arising directly or indirectly from any fixed asset not employed in an "economic exploitation" (trade). RIS Art 6 declares the presumption of income arising from any provision of services or goods, **in the absence of proof to the contrary**, such income to be calculated at its market (arm's-length) value.

If XYZ Ltd were actually in receipt of rental, its duty to declare for ISS would be clear. In this case, however, the Smiths occupy Casa Supadupa rent-free, and both they and the company have simply not considered the question of any tax liability arising from their occupation. Even a few years ago, this may have been a pragmatically successful, if unguarded, approach. However the Hacienda of today is a beast of a different colour; firstly, and for a variety of reasons, it is provoked - at the least into enquiry - by the mere existence of an offshore entity owning Spanish real property; secondly it has the capacity (currently being muscularly exercised in certain areas of Spain) to establish that a property has been occupied, by requiring information from the suppliers of such utilities as telephone, electricity and water, inter alia; thirdly (and parenthetically for the purposes of my present argument) it is calling the occupants for inspection, starting with Wealth Tax (IP); fourthly, having established that the property is occupied, it can assess the company to tax on the deemed rental income.

At this stage, the Smiths find themselves in a quandary: XYZ Ltd can provide proof that no income has in fact been received, by providing copies of its accounts, an auditor's certificate and a certificate from the directors to

¹² ISS - Impuesto sobre Sociedades (Law 61/1978 as amended). Taxation of Companies.

¹³ RIS - Reglamentos del Impuesto sobre Sociedades (Royal Decree 2631/1881 as amended). Regulations for the implementation of ISS.

that effect, which would satisfactorily (though at some compliance cost¹⁴) defeat the assessment of ISS. The result, however, would be to demonstrate that the Smiths had enjoyed gratuitous use of the property. Such use would, in general, be considered either as a benefit in kind if the Smiths were directors or other employees of the company (which, if true, would bring a whole host of further problems in its wake¹⁵), or as a gift, assessable to ISD on the Smiths¹⁶. Penalties and interest will be applied to tax which should have been declared and paid in an earlier year (pace the Fiscal Amnesty expiring at the end of 1991).

Form has got in the way of substance, and the Smiths will have to pay money for the privilege of living, and having lived, in what they regard as their own property. In this example, we do not know what perceived evil the Smiths were seeking to cure by use of XYZ Ltd, and therefore we cannot ascertain if the cure was worth the cost.

*** Inheritance tax (ISD)**

If the intended heirs to Spanish-sited real property are not resident in Spain, then leaving the shares of a super imposed company (or some analogous

¹⁴ ...and loss of confidentiality, which contains a number of dangers. For example, it would be clear that the company's sole asset was a property in Spain. This in turn could lead to an attempted application of the new "Companies Act" (Ley de Sociedades Anonimas - Law 19/1989 as amended). Art 5(2) says "companies whose principal establishment or exploitation is in Spain, shall have their domicile in Spain". Art 5(1) says "companies whose domicile is in Spanish territory will be (considered) Spanish and subject to this Law, irrespective of the place of constitution of the company". It is, of course at the least arguable that mere tenancy does not constitute either an establishment or, more to the point, an exploitation; occupation of the property may serve to weaken that argument.

¹⁵ ...for example: what are their duties, and where are they carried out? If in Spain, income tax declarations for the Smiths; Social Security contributions on their emoluments; work and residence permits; Permanent Establishment thereby created? See also footnote 14.

¹⁶ Probably assessed as a usufruct; different valuation rules for periods certain and lifetime - as a rule of thumb, 2% of the full market value of the property per year of tenancy, to a maximum of 70%; minimum co-efficient of 2 applied to the tax calculation, since there can be neither blood nor marriage relationship with a company.

manoeuvre) will avoid ISD. If those heirs¹⁷, however, are resident in Spain, they are assessable to ISD on their world-wide receipts, and prima facie the charge is not thereby avoided. The use of appropriately fashioned trusts may¹⁸ avoid a receipt of the property, or anything standing for it. Any use of the property, however, by the "heir" or others will suffer the problems outlined above, and if the (say) spouse benefits from a usufruct then that in itself is a chargeable asset (see footnotes 16 & 18).

*** Now you see me, now you don't**

Despite the best endeavours of their advisors, many clients engage in a game of chicken with Hacienda. They live in a property which they don't own; they simply pay no regard to the Spanish tax rules of habitual residence; they personally contract with the telephone and electricity companies (because they want "Smith" in the phonebook rather than "XYZ Ltd", and because the latter insists on a physical person); in short they leave a trail a mile wide. And, the worst sin of all, they presume that Hacienda's investigative powers and enforcement procedures are inadequate to the task of spotting them.

The new 5% tax

Into this witch's cauldron, the legislators have now dropped the new Special Tax (Impuesto Especial). This was heralded by a draft version which proposed an annual charge of 3% of market value and openly took the French property tax as its model. The prologue to the draft version was instructive as to the motives for the tax, and spoke of tax havens (*paraísos fiscales*) in the sorts of terms employed by old-fashioned Methodist ministers thundering about sin. Between the lines of the prologue one could clearly discern the focus on information-gathering, with the tax as the sanction for failure to provide information. Much discussion resulted, and various doubtful avoidance schemes were touted around the expatriate communities. This period was evidently of considerable value to the legislators in revealing loopholes through which Constable could have driven his haywain.

Officially published on 7 June 1991, the Impuesto Especial takes the following form.

*The tax is applied to all entities (a comprehensive term which would, however,

¹⁷ In this context, it is necessary to remember that spouses are not exempt beneficiaries, and that the ISD taxpayer is the recipient.

¹⁸ Spain is a signatory to the Hague Convention on Trusts, but has not ratified it. The treatment of interests in trusts is more than somewhat uncertain. It is to be expected (taking the "cold light of dawn" view) that an appointment - or, more certainly, a distribution - by trustees of Spanish-sited real property, or rights to the use or enjoyment thereof, will be chargeable to ISD as a lifetime transfer from an unrelated person; such charge would be at least double that which would have been charged on a direct transfer from a spouse.

exclude a physical person) not resident in Spanish territory which own in Spain real property or rights of use or enjoyment thereof.

*The tax is 5% of the catastral value (see footnote 7) of the property or right in question, and that figure may be changed by future Laws of the State's General Budgets. The tax accrues on 31 December each year (with no apparent provision for apportionment), and is payable during the following month of January. The law comes into effect on 1 January 1992, and hence the tax first accrues on 31 December 1992.

*Non-payment of the tax will be enforced against the property, without need for a court order, a certificate issued by the Hacienda administration being sufficient for possession.

*Exemption from the charge is made for:-

- A. Foreign States and their Public Institutions, and International Organisations.
- B. Entities which owned the property or rights in question before 4 August 1990, and which were resident before that date in a state with which Spain had signed a double tax treaty containing a clause for the exchange of information about real property and rights thereto.
- C. Entities which continuously or habitually engage in a trade in Spain, where the trade is distinct from the property or rights which would otherwise be subject to the tax.
- D. Where the entity can sufficiently satisfy the authorities (by procedures to be established by regulation¹⁹) of the origin of the

¹⁹ These regulations are not yet published at the date of writing, despite a statement that they would be available in "late September/early October 1991". No action can be recommended to clients until these regulations are available, despite the urgency to determine a reaction to the law for each affected client in case it is beneficial to make retrospective tax declarations under the terms of the Fiscal Amnesty which expires on 31 December 1991.

funds²⁰ used to acquire the property or rights, and of the personality²¹ of its direct and indirect owners and gives an undertaking to notify the authorities of any change²² in the latter, and of the reasons for such charge.

Planning for the Impuesto Especial - the metaphysical state of the art

As will be evident from all the above, beneficial owners want to know what they should do. The range of available reactions is quite wide. So too, however, is the range of considerations associated with each potential course of action. Again, the list below claims to be indicative rather than exhaustive.

1. Claim exemption A.

Either it applies, or it doesn't.

2. Claim exemption B.

Again, either it applies or it doesn't, the date-test being quite clear. The recent French/Swiss treaty case may, however, raise some interest in the possibility of challenge under the non-discrimination clause of an appropriate treaty. The wording of the law seems to defeat that possibility, in that no reference is made to the nationality of the entity, relying instead on residence, for which Spanish law adopts the test of seat of central management and control. The tax could therefore be equally applied to a Spanish company resident outside Spain.

3. Claim exemption C.

A trade involving the property, such as letting it, will not do. A boutique run in the premises probably would. It would not be a simple matter to run a "continuous or habitual" trade without creating a permanent establishment (EP) in Spain. If an EP were established Hacienda would require to see all the entity's books of account,

²⁰ A simple matter in some cases. In others, origin of the company's funds is precisely that which the beneficial owner seeks to conceal. In yet others, neither the current beneficial owner nor the company's managers can track the original owner (who was presumably the source).

²¹ In the continuing absence of the regulations (footnote 19), this raises huge questions where trusts, Foundations, or similar entities without "personality" are involved in the structural chain. In a discretionary trust, will they seek information about the settlor? In a trust with interest-in-possession, is the "personality" the trustees or the beneficiary? With the regulations in his hand, the professional advisor will at least be able to take a view.

²² Not only tracks "ownership", but also may raise a charge to ISD on, say, a resident shareholder. Will the entity always have or, indeed, be entitled to this information (changes in the class of objects of a superimposed trust)?

thereby exposing the global business/interests of the entity.

If the entity does actually trade, or commences to do so before 31 December 1992, then the exemption will apply. It would be a bit ticklish, but there is just a glimmer of a planning opportunity in this exemption for those clients whose circumstances are appropriate.

4. Claim exemption D.

This is the exemption on which most interest is focused. Evidently, it requires the original source of funds to be ascertainable, clean and without embarrassment to either the entity or the beneficial owner. It also requires that no problem arises on a declaration of ultimate beneficial ownership (which, in turn, implies a revelation of any intermediate chain²³). An owner, resident in Spain, may need to make "complementary" declarations for Wealth Tax (IP) of his shareholding, before 31 December 1991 to benefit from the Fiscal Amnesty, and to clean up the ground for the 1992 exempting declaration.

Patently, there are many beneficial owners who will fall at one or more of these hurdles. One of the concerns commonly expressed is the risk of a report under a Treaty or European Community term back to the country of origin, domicile or residence of the owner.

5. Sell the company.

An apparently drastic, but commonly considered solution. Evidently a successful one, if a suitable buyer can be found. But therein lies the rub. Not only is the property market severely depressed, but any purchaser would be the successor in title to at least some of the problems the vendor is thereby seeking to escape.

6. Sell the property out of the company.

This clearly defeats the problem of the Impuesto Especial, if completed before 31 December 1992. But again, first find your buyer. Next, consider that this contemplates a full legal conveyance of Spanish-sited real property and the associated costs (described earlier). Further, this would be a disposal of a (presumably) gainful

²³ Here there may be dragons. In a simple example, commercial/professional nominee shareholders may not wish thus to be exposed to the gaze of the Spanish authorities and may therefore insist on withdrawing.

asset by a non-resident²⁴ entity, and chargeable at 35% on the realised gain²⁵. It must be remembered that the company may have acquired the property some long time ago, despite possible intermediate changes of shareholder, and that the pregnant gain could therefore be large. This may be exacerbated by the time-honoured, but illegal, practice²⁶ of understating the price of the property in the title deed (*escritura*).

²⁴ From 1 January 1992, any person acquiring real property (or rights) from a non-resident is required to withhold 10% of the agreed consideration and pay it in to Hacienda on account of the disponent's liability to any tax due on the transaction, failing which the property in question will remain charged with the total tax liability of the vendor (which, of course, could exceed 10% of the consideration).

²⁵ Under current rules, companies do not benefit from any indexation of acquisition price.

²⁶ Already illegal, this practice was then doubly outlawed by the enactment of a special law (*Ley de Tasas*), combined with fierce new enforcement procedures. In short, the music has stopped, and he who holds the parcel is stuck with it.

7. Liquidate the company and distribute in specie to the shareholder.

(Popularly called "can't we just forget the company and put the property into my own name, dear boy?"). Prima facie, there is no reason to suppose that such action will avoid either the tax on realised gain in the hands of the company, or the transfer tax, notary's fees and so forth on conveyance of the legal title. There may, however, be some merit in considering this route where the gain is not too painful. There is also some professional discussion about whether such a conveyance can be reported²⁷ at 1% transfer tax rather than the normal 6% (for residential properties). The argument has most strength where the present shareholder is the original shareholder. It turns about a subtle, and yet robust, view of some of the words of the relevant laws²⁸. Certainly, there are some cases where it may be worth trying; if Hacienda rejects the attempt it will reassess, and add a penalty (probably of 20%) to the difference of 5% (making 7% in all). The risk may be worth taking in some few circumstances.

8. Interpose a Spanish resident company.

Such a manoeuvre, completed before 31 December 1992, takes the matter outside the purview of the Impuesto Especial. It is not clear whether Hacienda or the Government would see this as a mischief; if they did, it would be relatively easy to cure with new or amended legislation. The solution has some attraction, but may be short-lived if it is perceived as general abuse.

Once again, there would be conveyancing costs and tax on realised gain, unless the existing property-owning company were migrated into Spain.

Naturally, such a company would be exposed to the full panoply of the Spanish law and compliance - not necessarily onerous, but certainly different.

9. Pay the tax.

Deceptively simple, and to some clients may appear more attractive than other, more revealing or complex, alternatives. There is nothing in the legislation to suggest that this is not a perfectly proper and acceptable, if expensive, course of action. There may, however, be some dangers in this. It is already fairly clear that Spain prefers information to the 5% tax take. It can also be inferred that an election to pay the tax in preference to providing information implies that there is something to hide. It may not be starting at shadows to suggest that those who elect to pay the tax are thereby shuffling themselves into the bull of the target for next year's legislative round. It should not be forgotten that the figure of 5% can be amended by the Laws of the State's General Budgets every year.

This approach should, however, not be entirely discarded. Despite what may be the longer-term dangers of payment, it may be a perfectly legitimate short-term tactic within the context of a longer-term strategy. It is quite possible to contemplate, for

²⁷ Spain's is a self-assessment regime.

²⁸ Inter alia, Disposicion Transitoria 3(c) of the Transfer Tax Law (see footnote 3), Art 108 of the Stock Market Law (Ley 24/1988), and Art 6 of theCodigo Civil, which latter enunciates a generally applicable motive test on the matter of tax-avoidance.

example, an entity electing to pay the 5% in respect of 1992, with a view to other, different, arrangements which cannot be completed until, say, 1993.

10. ... and out into the wild blue yonder.

The proposals for the new Société Européenne, and its ability to absorb, without change of legal personality, two or more existing companies of member states, may offer some planning opportunities from 1993 onwards.

What should a new buyer do - direct, company or what?

This inevitable question is in reality seeking general guidelines. It might be restated as "is there a rule of thumb?" The equally inevitable answer is, frankly, "no". It is possible to envisage the construction of a sort of vade mecum, perhaps taking as a major index of judgement the residence (in Spain or not) of the beneficial owner. But any such would be so hedged about with caveats as to be of little practical use, and in the wrong hands would be positively dangerous.

Then is the offshore structure for Spanish property now dead?

Rather as with motor-cycles, any danger derives more from the rider than from the machine. The offshore structure remains as valuable a planning tool as it always was. Its shape may have changed a little, and the circumstances of its use somewhat narrowed or refined. This is powerful medicine, and should only be available on prescription.

POSTSCRIPT

- 1 A sneak (and therefore not entirely thorough) preview of the draft Reglamentos for the Impuesto Especial (which, in draft, look very thin and leave open more questions than they answer) suggest that the authorities will look for the following:
 - a) in respect of the "also trading" exemption, in order to avoid a sham, the trade must show an annual turnover of the lesser of 100 million pesetas (in round terms £500,000) or 4 times the catastral value of the property or right which is the object of the tax.

- b) in respect of the declaration of source of funds, the name of the physical or juridical person resident in Spain, or of the physical person resident outside Spain, who originally provided the funds.
 - c) in respect of the declaration of beneficial ownership, the ultimate physical person in the chain. There is some suggestion (not contained within the words of the draft Reglamentos) that the authorities will be satisfied with a public limited company (more than 50 members), and will stop at the non-corporate trustee of a discretionary trust, but will wish to look through to the beneficiaries of a trust with interest-in-possession.
- 2 Anecdotal information suggests that footnote 24 to this article (which refers to the 10% retention) should be amended to say that in the event of non-retention (or failure to pay-in the retention) the property will remain charged with the 10%, but not with any greater amount of tax which may be due from the transferor.
- 3 As will be apparent, there is some way yet to go before practice in these matters becomes entirely clear.