The Offshore Tax Planning Review

SPANISH PROPERTY TAX (5% IMPUESTO ESPECIAL): THE REGULATIONS DETAILS AND COMMENTARY

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Preamble

Spain has been moving with some energy to cure what it perceives to be an evil. The general topic of the ownership of Spanish-sited real property via foreign (generally offshore) entities has been the object of close scrutiny and some legislation. The Spanish state has felt, with more than a little justification, that such structures have avoided many of the fiscal and financial controls and safeguards which apply to directly-owned real property (and rights to the use and enjoyment thereof) and that certain abuses including the laundering of the proceeds of crime and drugs have thereby been facilitated. The abuses have included evasion as well as avoidance of exchange controls (now largely historical), money-transmission reporting requirements, and taxes on income, wealth, and inheritances and gifts. The evaders/avoiders have been of both Spanish and foreign nationality, resident and non-resident in Spain. Resulting from this concern some pieces of, inter alia, tax legislation (including the 5% Impuesto Especial - see *The Offshore Tax Planning Review*, Volume 2, 1991/92, Issue 1, p.27) have been enacted.

Introduction

Necessary to the accurate interpretation of any Spanish tax law are the associated regulations (*Reglamentos*) - as it were, practice notes but with statutory force, subordinated only to the relevant Law *(Ley)* itself. Many practitioners and clients have been awaiting the publication of the Regulations for the Impuesto Especial, since it has been difficult to formulate clear advice in their absence, except in the most straightforward of cases.

Their wait has been rewarded - though that may prove to be too strong a word - by the publication on 31st December 1991 of Royal Decree 1841/1991 dated 30th December

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1991 approving, inter alia, the *Reglamentos* for Personal Income Tax (IRPF[2]), which include those for the Impuesto Especial.

I am reminded of the procreation of giant pandas, where conception is difficult, gestation is long, and the result very small indeed. I also understand that the infant is pretty feeble and emerges with only a precarious hold on life. The first part of my analogy is reasonable accurate; I am not so bullish about the second.

There is much of interest, including several lacunae. And, sneaking quietly in from the wings of the general IRPF Reglamentos, there is Hacienda's[3] crude new mechanism to attack the avoidance of Spanish tax on gains from real property via non-resident companies. (I have some doubts about the total effectiveness of the latter, but it is evidently going to be something of a fishbone in the throat.)

Aim of this Article

This article rehearses the details of the Reglamentos for the Impuesto Especial and associated matters. It discusses the effects of them in planning for this tax, and offers some conclusions.

Some clear (and, on occasion, hard) decisions need to be taken by those responsible for companies and other entities affected by the tax during the course of 1992. These decisions are not uniquely a problem for beneficial owners; trustees and company managers may seek the comfort of instructions from their clients, but uninformed instructions may be more damaging than none. It is not too early to start the decision making process, even though the resultant compliance activity is not needed until December 1992. This article aims to assist in that process.

Background

Spain has enacted several pieces of legislation bearing on the topic of non-resident property owners, whether direct or via a third party structure such as a company or trust. Chief amongst those is the Impuesto Especial. Others include the following:

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2 *Impuesto sobre la Renta de las Personas Fisicas*

3 Hacienda - Spain's equivalent of the UK's Inland Revenue.

* All persons, physical or juridical, resident or not, with an economic interest in Spain[4] must obtain a Fiscal Identity Number[5]. There are penalties for non-compliance.

* All non-residents (physical or juridical) with economic interests in Spain must appoint a Spanish-resident Fiscal Representative. The penalty for failing to appoint, or failing to report the appointment, is a fine of up to Pesetas 2 million (£11,111 at 180:1)

* All purchasers (resident or not, physical or juridical) of real property[6]sited in Spain from a non-resident[7] (physical or juridical) must retain 10% of the agreed price and pay that in to Hacienda[8], failing which the property in question will be charged with the 10% and may be sold to realise that amount plus costs.

Finally, here is a swift outline[9] of the Impuesto Especial to which the Reglamentos, which are the subject of this article, apply.

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4 An economic interest in Spain is widely defined. Matters as apparently incidental as signing a contract for the supply and use of a telephone are included. Generally, if one has to pause and consider if a matter constitutes an "economic interest" for this purpose, then it almost certainly does.

5 .... known as the NIF for individuals of Spanish nationality, NIE for non-Spanish individuals, and CIF for companies, etc.

6 .... unless the property in question has been owned, unimproved, for more than 20 years by the vendor. In such cases the vendor must swear a public document attesting to the absence of improvements to the property. These seemingly baroque requirements derive from the exemptions from tax on realised gain.

7 .... without a Permanent Establishment in Spain.

8 .... within one month of the date of the transaction.

9 What follows is of necessity a mere thumbnail sketch. By definition, therefore, it is extremely abbreviated and much of the detail absent. Full details were given in Issue 1 of this Review.

The tax applies to non-resident entities (not physical persons) which own in Spain real property or rights to the use and enjoyment thereof. The tax is an annual amount of 5% of the *valor catastral* (quasi rateable value) of the property or rights in question. There are four circumstances[10] in which the taxable entity may apply for an exemption from payment:

A. Where it is a foreign state, a public body or institution thereof, or an international organisation.

B. Where it owned the property or rights before 4th August 1990 and was resident in a treaty country[11] before that date.

C. Where it engages in Spanish territory in a bona fide trade which is distinct from the property which is the object of the tax.

D. Where by declaration it sufficiently satisfies the Spanish authorities as to:

   a) the source of funds with which the property was originally purchased, and

   b) in whose hands lies ultimate ownership or control (of itself, the property-owning entity and its parental chain) and

   c) an undertaking to notify the Spanish authorities of any change in b).

What the Regulations Say .....and What They Do Not

The Regulations are to be found in Title VII of the IRPF Regulations. Perhaps bafflingly to the uninitiated, the opening article of that Title proclaims that everything within it is applicable not merely to Personal Income Tax, but also to Company Tax (ISS[12]). Art 74 (which contains the whole of the Regulations for the Impuesto Especial) commences with a paraphrased version of the Law for purposes of orientation, and gives some administrative details about which tax offices can receive declarations or applications for exemption. Importantly, it also states that the process of enforcement of undeclared/unpaid tax can start immediately following the expiry

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10 Which I have lettered A to D. They are not so lettered in the Law or the Regulations. The letters are a convention I adopted for ease of reference in my earlier article, and are consistently maintained in this.

11 The treaty must contain a clause for the exchange of information concerning real property and rights derived from property

12 Impuesto sobre Sociedades. Analogous to UK corporation tax and applies principally to companies, but also to other forms of "society" not caught by taxes specific to their nature or constitution.

of the period allowed for declaration and payment[13].

Exemptions A and B

No mention whatever (apart from the bald restatement of them) is made of exemptions A and B. Patently the Spanish Ministry of Finance considers that they are plain and clear enough, and that applications for these exemptions will stand or fall on their merits. I guess that it not an unreasonable view, and I think the law on residence of companies (or rather, *sociedades*) is probably man enough for the job .... that is, until one considers the question of trusts[14]. This is an exceedingly vexing area for the Anglo-Saxon planner. Of course, the problem is that there is no such animal in Spanish law; therefore it does not exist; therefore it cannot hold assets, nor itself be resident[15], nor perform any legal function for the purposes of the Spanish law. The consequences of all of this affect much of what follows in this article.

Exemption B

An interesting feature is the absence - in the Law as well as the Regulations - of any requirement for the entity to continue to be resident in a treaty country after 4th August 1990. Whether this is intended, or an omission or error of drafting, is not clear. Except in aberrant cases, it probably does not offer too many planning opportunities.

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13 The liability accrues on 31st December each year (first year 1992), and the tax must be declared and paid during the following month of January. Enforcement proceedings will therefore start on 1st February. Readers of my earlier article will recall that a certificate issued by the Hacienda administration is sufficient to charge the property concerned for this purpose, and no Court intervention is required.

14 Although Spain is a signatory to the Hague Convention on Trusts, it has not ratified it. In consequence Spain cannot recognise beneficial interests, nor consider trust assets to form a fund separate from personal assets of the trustee(s).

15 My statement is correct as it stands; however beware the possible trap of a species of "resulting residence". Art 33 of the General Tax Law (*Ley General Tributaria*) holds that " .....other entities without legal personality which constitute an economic unit or separate fund of assets" may for the purposes of the tax laws be liable to tax.

Exemption C

Clause Five of Art 74 gets into the meat of the matter, and gives some quite clear criteria against which Hacienda will judge whether or not there exists a bona fide trade which may be distinguished from the property which has caused all the excitement in the first place. Any of the following circumstances will do, it says:

a) Where the **market**[16] value of the property[17] does not exceed five times the **market** value[18] of the fixed assets of the trade.

Interestingly, it is evidently contemplated that property may be employed partly in trade and partly not. Where this is the case, the taxable base for the charge to the Impuesto Especial is the catastral value of that portion of the property not employed within the trade. Evidently this regulatory provision (which is in the indicative, not the subjunctive, mood) appears to offer the crafty planner a possible mechanism for reduction of the taxable base. It should be observed however that, by virtue of the trade, inter alia, it will be difficult to avoid a Permanent Establishment. An overall tax saving may be possible, but the skills of a drunken yet still live tightrope walker may be needed to achieve that.

Clause Five (a) goes on to say, with the air of one distributing largesse, that where the trade cannot be distinguished from the property itself, the taxable base for the Impuesto Especial will be restricted to the catastral value attributable to that portion of the property not employed in the trade. Here, of course, lies an opportunity for the planner similar to that mentioned above, although the circumstances are considerably wider in my view, and I am not sure that the draftsman intended it that way. Take, for example, a company owning property in Spain, letting the whole of that property by way of trade, and paying its Spanish tax on the rental incomes. It seems to me that the Impuesto Especial will effectively be avoided by the unlikely route of an application for an exemption which will not be granted, but which establishes that a trade does in fact exist, indistinguishable from the real property but inevitably employing it in the trade, and therefore that the residual value to which the Impuesto applies is nil. It appears prima facie that Hacienda would have no statutory or regulatory grounds on which to resist such an outcome.

b) Where the annual volume of operations (turnover) of the trade equals four times or more the catastral value of the property.

c) Where the annual volume of operations of the trade is one hundred million pesetas (£555,555 approx) or more.

Exemption D

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16 Note market value, not catastral value

17 Whether the entity owns the property directly, or merely owns rights of use or enjoyment of a property, it is the value of that property (and not of any right derived therefrom) which is relevant for this regulation.

18 i.e., not necessarily the book or accounting value

This is the exemption on which most interest is focused and about which there are probably most questions. The Regulations concerning it (in Clause Six of Art 74) deal with the principal components separately:

* Declaration of source of funds

It has been a concern, in the interregnum between publication of the Law and publication of the Regulations that many entities (particularly companies) may be unable to trace the original investor, and hence the original source of funds with which the entity first acquired the Spanish property. The Regulations neatly remove that worry by simply not requiring it. However, in its place there is a rather mild sounding requirement but one which may prove to be a bombshell to many property-owning companies. The Regulation states simply that the source of funds will be considered sufficiently established by proof that the inward investment was effected and formalized in accordance with the laws of foreign investment[19]. The regulation envisages no other method of accrediting the source of funds. The bombshell is this: during the Wild West days of Spanish property acquisition via offshore companies, many were purchased with scant attention to the controls on inward investment, and often with deliberate evasion of those in order to facilitate, inter alia, the illegal export by the vendor of the proceeds of sale[20]. Unguarded and, more to the point, ill-advised purchasers (whether directly or at second-hand as subsequent purchasers of the property-owning company) assumed the continuing risks inherent in accession to such activity.

It would therefore seem that prima facie those entities without proof of fully legal inward investment (which would normally be attached to the copy of the *escritura publica* [title deed]) will be unable to claim Exemption D. It may, however, be possible to cure the original illegality post facto where the circumstances are appropriate. It is beyond the scope of this article to describe the various processes which may be employed; suffice to say that the circumstances of each case will determine whether it is possible or advisable, and whether complicated and costly or less so. Some cases will be incurable.

* Ultimate owners/controllers

This whole area is fraught with questions for those responsible for offshore structures, and their advisors. The little chunk of sub-legislation (that is, the

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19 A process overseen and controlled by the DGTE (*Direccion General de Transacciones Exteriores)* aided by the banks and the National Police (both of whom had a role to play in exchange controls) and by the notarial and property registration processes.

20 This was not the only illegal practice forced upon buyers; others included the acceptance of a fraudulently low price stated in the purchase sale contract, thereby reducing apparent realised gain for the vendor and leaving the purchaser not only having committed a serious offence but also stuck with the pregnant balance of the gain. A rising market, the associated fear of being gazumped and, of course, ignorance made these practices possible.

Reglamento) dealing with the matter is notable for its po-faced righteousness. It avoids being of help with such matters as equitable title, the position of trustees, and anonymous but legal entities. That such things exist, and are numerically significant in Spanish property ownership, is well known to the Ministry of Finance; that they do not fit the terms of the Law or the Regulations has not escaped their attention[21]. That Hacienda has cynically ducked the whole, admittedly difficult, issue and, more crucially, appears to intend to play a hidden hand is unforgivable, and not in keeping with the modern spirit in Spanish tax legislation of being helpful and open.

Despite being in my view inadequate to its task, the Reglamento is nevertheless of considerable help where the property-owning structure is composed of companies. The "legal representative" (that is, an appropriately authorised officer) of the immediate property-owning entity must in a formal document identify to Hacienda the "personality of the owners, direct or indirect, of the social capital of the entity, or the majority thereof". It goes on to make clear that it is looking for physical persons, and a statement of their nationality, current country of residence and permanent address. However, where the majority of the "social capital" is directly or indirectly owned by a juridical person with more than fifty physical persons as shareholders or which is quoted on an officially recognised stock-exchange, the ultimate centre of decision and the physical person or persons responsible must be identified.

Several questions arise from this when considering trusts. Who are the "owners" (*titulares*) of the "social capital"? Is it the trustee, or is it the beneficiary? Does the answer to that question change, depending upon whether the trust is discretionary or with interest in possession? There is of course no guidance in the Reglamento, and one is therefore forced somewhat into the land of the crystal ball[22]. We have sought some elucidation from Hacienda, but asphyxiation is the likely result of holding one's breath for an early reply.

In the meantime there is some reason to suppose that they will pursue the trustee chain in a discretionary trust, and the beneficiary chain where there is an interest in possession. At first glance, that approach has some logic (in that it shares that of the Reglamentos); but there is a problem. Noting the requirements to keep Hacienda on notice of changes in the ultimate beneficial owner, there are many potential circumstances in which such a report will be required, for example: resignation of trustees; appointment of new trustees; change of address of trustees; changes in beneficial interest, whether by appointment of the trustees or by operation of some automatic accrual clause or contingent event; changes of address or residence of beneficiaries with interests in possession. Where the trust is the shareholder of the property-owning company (which latter is the taxable entity and has given the undertaking to Hacienda) it is not clear that the company will be in possession of, or even entitled to know, such information; nevertheless, failure to report such changes will be a breach of the undertaking, leading ultimately to enforcement of the tax. Patently, those responsible for the taxable entity need to ensure that they are empowered to give and carry out the undertaking.

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[21] This statement in this clause derives from personal knowledge based on dialogue with a senior officer of Hacienda.

[22] ....certainly until Hacienda reply to formal enquiry on this topic. There is evidence that they have thought about the matter, although nothing has been published.

As will be clear from the foregoing, the fog of war has not yet lifted. Indeed, I guess we have still to witness the opening skirmishes where trusts and the like are concerned. I feel reasonably sure that in due course a modus vivendi will be arrived at, and hence some certainty of outcome for planners and their clients will emerge. Volunteers for test cases are welcome!

* Administration

The Reglamento requires applications for Exemption D to identify the property/ies which the applicant owns in Spain, and to attach a copy of the most recent "rates" *(contribucion urbuana)* receipts together with an authenticated copy of the public documents evidencing the legality of the original investment, and the necessary information about ultimate owners.

Based on this application the *Direccion General de Tributos* will issue a formal resolution granting or denying the exemption. Appeals may be made in accordance with the normal process for tax appeals.

The grant of an exemption will be valid only from the date of presentation of the application, and will never be retrospective.

What Else is New?

IRPF Reglamentos Art 70 (entitled "Income obtained in Spain by non-residents") at Clause One (j) is rather worrying, on a number of fronts. It says:

> *j)* *Realised gains derived, directly or indirectly, from immoveable property sited in Spanish territory or rights related thereto* [will be considered gains produced or obtained in Spanish territory]
>
> *In particular, the following will be included:*
>
> *1.* *Gains derived from rights or shares in a company or entity, resident or not, whose principal activity is in immoveable property sited in Spanish territory.*
>
> *2.* *Gains derived from the alienation of rights or shares in a company or entity which attribute to the owner* [of those rights or shares] *the right to* [use or] *enjoy immoveable property sited in Spanish territory.*

It is worth reiterating that this Article refers specifically to non-residents. What we have here is a sweeping piece of extra-territorial taxation which, for example, purports to catch the disposal of shares in a Hong Kong company by a Canadian resident in Greenland. I do not need to list my multiple reactions to this.

However, it is worth relating this provision to the conditions precedent to the granting of Exemption D from the Impuesto Especial. Hacienda wish to know who currently are the owners, direct or indirect, of the company or entity which owns the Spanish property. They also require an undertaking to inform them of any changes in that. The link is clear.

One may argue that the extra-territorial effect of Art 70 One (j) is, say, unenforceable.

But a failure to comply with the undertaking will result (at the least) in the Impuesto Especial becoming payable, and at the end of the chain there is the hostage of the Spanish-sited immoveable property.

The provision talks specifically about the "alienation" of rights or shares. Is an appointment of interest away from a beneficiary an alienation? For Spanish purposes? How about retirement or resignation of a trustee?

It seems likely that the principal objective of Art 70 One (j) 2 (above) is to catch the transmission of shares or rights in time-sharing schemes based on Spanish Property. It is also likely that the principal target is not the hapless owner (who, in my view, may have some difficulty in actually showing a gain) but the original owner/developer/promoter of the scheme[23]. If this is indeed the case, the chosen weapon is more of a low-yield nuclear bomb than a hunting rifle, and many non-contestants will be at risk of injury, if not vaporisation.

Self-evidently there is, as yet, neither practice nor jurisprudence to guide us. And nor will there be, in theory, until some time after 31st December 1992. Nevertheless, decisions have to be taken before then, and therefore views adopted on proper courses of actions for clients. The field is wide open, and absolutely must be narrowed in some way.

Conclusion

Helpful though they are, the Reglamentos still leave open (and indeed, have newly created) a massive number of questions. Mere application of logic and academic process seems inadequate to solve them in a manner which produces any predictability of outcome for clients. The next step must be to seek clarification from Hacienda.

I fear, therefore, that the correct conclusion for this article must be .... "Watch this space".

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[23] Hacienda are known to have been considerably provoked by the many such schemes which have allowed time-share companies to take massive gains outside Spain when selling on to the general public.