SPAIN 1995: PROPOSED CHANGES IN THE 5% SPECIAL TAX

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Introduction

At the date of writing this article, there is a bill before the Spanish parliament which would consolidate and amend the *Ley del Impuesto sobre Sociedades* (Corporation Tax Law)[2]. The proposed amendments include major changes to the 5% Special Tax on the Spanish property of non-resident entities[3]. This article rehearses those proposed changes, and offers some brief commentary thereon. In addition, two possible planning manoeuvres are proposed, examined, and largely rejected.

The great majority of non-resident entities which own property in Spain are established in offshore jurisdictions. For purposes of orientation, therefore, this article opens with some comments on tax havens from the Spanish perspective. Spain has a relatively recent preoccupation with these "fiscal paradises" which have generated a climate of suspicion thereof in the minds of the officials of fiscal and other authorities. It is valuable for the planner to have this climate in mind when considering tax-planning - and even commercial - structures.

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2 Of course, passage of the bill into law may be swifter than publication of this article. The writer therefore apologises in advance in case the information and commentary in this article are overtaken by events.

3 Concerning which two articles were published in earlier issues of the OTPR. It would certainly assist the reader of this article to have access to those earlier articles.

TAX HAVENS (PARAISOS FISCALES) GENERALLY

Until 1991, Spain had no definition in law or jurisprudence of what is a tax haven, despite earlier provisions that exemption from withholding tax in certain transactions was to be denied where the operation was carried out via a tax haven, or the proceeds realised/received in a tax haven. That was cured by the enactment of Royal Decree 1080 of 5th July 1991 consisting of one single article containing a list of jurisdictions which would for Spanish purposes, be considered tax havens. The list holds no real surprises, and is reproduced below for information. The Royal Decree provides that changes to the list may be made at any time. The legislation still contains no definition of what constitutes a tax haven for Spanish purposes, though I suppose that I should not carp at this since the prescriptive device of a list provides for greater certainty at least for the actual moment.

Paraisos Fiscales

Andorra	Cayman	Isle of Man	Malta	Seychelles
Anguilla	Cook Islands	Jamaica	Marianas	Singapore
Antigua and Barbuda	Cyprus	Jersey	Mauritius	Solomon Isles
Aruba	Dominican Republic	Jordan	Monaco	St Lucia
Bahamas	Falklands	Lebanon	Montserrat	St Vincent & Grenadines
Bahrain	Fiji	Liberia	Nauru	Trinidad & Tobago
Barbados	Gibraltar	Liechtenstein	Netherlands Antilles	Turks & Caicos
Bermuda	Grenada	Luxembourg (in respect of 1929 companies)	Oman	UAE
BVI	Guernsey		Panama	US Virgin Islands
Brunei	Hong Kong	Macao	San Marino	Vanuatu

There is no doubt that, throughout both fiscal and investment control legislation, tax havens are considered A Bad Thing. The mechanisms so far adopted to reflect this ideology tend to be relatively crude compared with, say, the UK's more experienced approach. The result is often peripheral or collateral damage - the sledgehammer and the nut come to mind. It is also the case that at the practical enforcement level (local and district office equivalent) the mind of the official perceives only three colours: shining white for those jurisdictions which have a double tax treaty with Spain; muddy grey for those which do not, but are not included in the list of tax havens; and deepest suspicious black for tax havens.

This usually impedes rational discussion with the official handling a particular case, and the result is often less than fully rewarding. Even at the higher, more technical, levels of fiscal officialdom, it is sometimes difficult to struggle one's way through prejudice to the relative sanity of interpretation based on the words of the statutes.

THE 5% SPECIAL TAX ON SPANISH PROPERTY OF NON-RESIDENT ENTITIES (IMPUESTO ESPECIAL SOBRE BIENES INMUEBLES DE ENTIDADES NO-RESIDENTES)

In summary, the existing law (enacted in June 1991, with effect from 1st January 1992), provides that:

(1) Non-resident entities (companies, trusts, etc, but not physical persons) shall pay an annual tax of 5% of the catastral value of their Spanish-sited property (and/or rights to the use and enjoyment of property sited in Spain), unless they qualify under the terms of and are granted upon application one of the following exemptions:

- (a) Foreign States and their public institutions and international organisations.
- (b) Entities which before 4th August 1990 were resident in a state which had a double tax treaty with Spain (providing for exchange of information), and which owned the property in question before 4th August 1990.
- (c) Entities carrying on a bona fide trade in Spain, distinct from the property in question.
- (d) Entities which provide evidence of the source of funds used to acquire the property, proof of the personality of the ultimate owners/controllers of the entity, and an undertaking to notify the Spanish revenue authority of any change in the latter.

(2) The tax accrues on the 31st December each year, and is payable during the following month of January.

(3) Exemptions must be claimed, and may not be granted with effect prior to the date of application.

(4) Revenue may seize the property, without Court Order, if the tax due is not paid.

The amendment is contained in Article 64 of the new draft Corporation Tax law. interestingly, its title has changed from "Impuesto Especial" (Special Tax) to "Gravamen Especial" (Special Levy). This change of name has no practical effect for tax payers. The Special Levy, where paid, will continue to be an allowable deduction for corporation tax (Impuesto sobre Sociedades) in Spain, on the same basis as the predecessor (albeit still current) Special Tax. The major changes proposed are:

(1) The tax falls from 5% to 3% of the catastral value of the property (and/or rights to the use and enjoyment of property) sited in Spain.

(2) The list of exemptions increases from four to five but, significantly, the exemption mentioned at paragraph (1)d above disappears. The new list of exemptions (in summary) is available to:

(a) Foreign States and their public institutions and International Organisations (no change).

(b) Entities with the right to the application of a double tax treaty with Spain (containing provision for exchange of information) where the ultimate owners have a similar right. Certification of those treaty rights is required from the relevant fiscal authorities.

(c) Entities which on a continual or habitual basis operate a trade in Spain distinct from the simple holding or letting of the property in question.

(d) Companies quoted on officially recognised stock exchanges.

(e) Non-profit making entities of a charitable or cultural nature recognised as such by the laws of a state with a double tax treaty with Spain. The property in question must be used for the purposes or object for which the entity exists.

(3) Where two or more entities jointly own property, there is a provision for apportionment of the Special Levy.

(4) Under exemption (b) above, where one or more of the ultimate owners does not meet the requirement for benefit from a treaty, the Special Levy will be apportioned appropriately.

It is expected that the bill will be enacted in substantially the form outlined above during the course of 1995. There is currently no information available on any transitional arrangements[4], though in this regard nothing unexpected is anticipated. The most likely effective date for the new legislation is 1st January 1996 which would mean that the new 3% Special Levy would first accrue on 31st December 1996, for payment during the following month of January 1997. The 5% Special Tax would therefore continue in force for fiscal 1995, payable (in the absence of an exemption) during January *1996*. *It is, of course, possible that the new* provisions will have an earlier effective date than 1st January 1996, in which case it will be interesting to see what transitional arrangements are made for the phasing out of the old 5% Tax.

COMMENTARY

It should perhaps first be said that the proposed annual tax of 3% of the property's "rateable" value is not dissimilar in financial effect to the French property tax, which appears to excite far less general hue and cry than the present Spanish 5% analogue. As always, in considering what action or reaction to the new legislation may be appropriate, it is possible that the balance of benefit may lie in simple inaction. An annual tax of 3% may be considered acceptable as part of the cost of company ownership, by at least some beneficial owners.

The great majority of those who have so far applied for exemption from the 5% Tax have done so under the "declaration of beneficial ownership" exemption. It appears that this exemption will cease to be available from the effective date of the new legislation. Even where this exemption from the 5% Tax has been granted therefore, most trusts, companies and other non-resident legal entities owning Spanish real property will need to reconsider their position, and determine an appropriate plan of response to the 3% Levy. Depending upon the effective date of the new law, this may need to be well before the end of the current calendar year. In any event the position should, with some celerity, at least be considered.

Many timesharing schemes, in particular, will need to examine the impact for them of this proposed legislative change. Many schemes employ offshore companies as the immediate property owning vehicle. Exemption from the 3% Levy will not be available for such structures as they stand. Several possible courses of action spring to mind, including structural changes. The precise structure - and possibly the operating philosophy also - of the scheme will determine which of those possibilities may be applicable to an individual case. The various possibilities appear prima facie to centre around the following options:

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4 These are made by way of "Transitional Dispositions" included within the body of the Law, or of the Royal Decree enacting modifications to an existing law and hence published at the same moment as the new Law itself.

- Do nothing except perhaps to absorb the 3% or pass it on to beneficial owners.

- Restructure to take the owning companies out of the scope of the Levy. One way to achieve this would be to interpose a Spanish resident company (resident entities are outside the scope). This can be very expensive (excluding company formation costs, it could amount to 8%[5] of the market value of the inventory plus 35% tax on the gain realised on the restructure - no roll-over relief would be available). Another approach may be to consider immigrating the property-holding companies into Spain. This possible mechanism is examined further on in this article, though not with specific reference to timesharing.

- Restructure (or migration of residence) in order to position the owning companies to benefit from an exemption. The only two realistic possibilities are the "also trading" exemption (which is briefly examined below), and the exemption for benefit from a tax treaty. The latter holds some considerable practical difficulty, since complete exemption would also require all the beneficial owners personally to benefit from a tax treaty with Spain.

THE "ALSO TRADING" EXEMPTION

This is, in most cases, an impractical approach for the normal property-owning company. Any attempt to make such a company fit the requirements would distort the structure and objective out of all reasonable shape. Nevertheless, for timesharing companies, and for some few others, it may be an approach which merits investigation.

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5 The major component of this 8% is the 6% stamp duty on the conveyance of residential property. It is possible that the tax authority (which for this tax is the regional government of the autonomous community in which the property is situated or the operation carried on) may accept that the transaction is a corporate operation (*operación societaria*) and so dutiable at 1% (rather than the 6%). I would be nervous in being prescriptive about this latter, however. Firstly, both arguments hold some prima facie validity. Secondly, in Andalucia at least, there is some evidence of preference for the 6% view (which can, of course, be appealed in a particular case). There is another whole can of worms in which IVA (VAT) at the standard 16% rate could be incurred rather than the stamp duty.

Since in order to be liable to the 3% Levy, the company is a non-resident of Spain, any trade in Spain would be conducted by way of permanent establishment.[6] (It is, I suppose, just barely feasible that a trade may avoid being a permanent establishment, but I doubt if that would help the case.) That said, the matter becomes a question of whether any actual or putative trade meets the volume requirements. Simply opening an office, and filing Spanish tax returns from there does not, per se, meet the terms of the exemption. The existing Regulations provide a very careful definition of what constitutes a "differentiable trade" for the purposes of the 5% Tax.

In summary, they provide that such a trade exists[7] where:

(a) The "real" (note, not catastral) value of the real property in question is not greater than five times the real value of the assets/property forming part of the trade, or

(b) the annual volume of operations is equal to or greater than four times the catastral value of the property in question, or

(c) the annual volume of operations is equal to or greater than 100 million pesetas.

The proposed change of law (5% to 3%) may bring with it a change in regulation and hence in the volume/value tests for what constitutes a trade for the purpose of this exemption. One would need to avoid planning on the basis of the old regulations unless there were a strong indication that they will remain substantially unaltered, and at the moment no such indication is available. Speculation doesn't

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6 Permanent Establishment (PE). Since almost by definition we are considering a company resident in a territory which does not have a double tax treaty with Spain, the Spanish definition applies. The Corporation Tax Law 61/1978 (the proposed amendments to which are the spur to the writing of this article) Art 7° determines that a PE will exist when a corporation " ... directly or by way of an attorney has in Spanish territory a seat of management, branch, offices, factories, workshops, installations, warehouses, shops or other establishments, construction installation or assembly works when the duration thereof is longer than twelve months, agencies or representatives authorised to contract for and on behalf of the taxpayer corporation or when it owns mines, quarries, petroleum or gas wells, or is engaged in agriculture, forestry, fishery or any other place or means of extraction of natural resources or carries out professional artistic activities, or possesses other places of work in which all or part of its activity is performed". In short, not much escapes the net.

7 Even where one of the criteria is met, the exemption must be claimed, and no exemption may be granted with an effective date prior to the formal submission of that claim.

help a lot either; I can readily construct arguments both for leaving the regulations as they stand, and for some radical changes.

It should be noted by those considering this mechanism as a possible route to exemption from the 3% Levy that the compliance requirements are heavy[8], and that the costs thereof can be considerable. Prudence suggests that this route only be adopted where a trade already exists or is genuinely contemplated.

IMMIGRATION INTO SPAIN OF THE NON-RESIDENT COMPANY

A non-Spanish company can be immigrated into Spain and become resident. A resident company is not liable to the 5% Tax, nor to its successor the 3% Levy. In short, the manoeuvre contemplated here takes the company out of the scope of the Levy. There is, therefore, some prima facie attraction in this. Regrettably, however, my conclusion is that, upon examination of the proposition, the attraction wanes pretty rapidly.

I start with the assumption that the company is registered in a tax haven, and is presently resident there. Spain has no double tax treaties with such jurisdictions, and hence the issue of residence in Spain must be determined by Spain's law. Corporation Tax Law (Law 61/1978) Article 9[9] provides that a corporation will be resident in Spain if any of the following are the case:

(a) The corporation is organised under the laws of Spain;

(b) The corporation's registered address ("domicilio social") is in Spanish territory;

(c) The place of effective management (PEM) is in Spain.

Following my assumption, (a) would not be the case; (b) is theoretically possible to achieve in isolation from (c) though doctrinally the *domicilio social* is perceived as complementary to residence, and hence in reality to the PEM; (c) therefore is the most likely possibility as a voluntary act giving the desired result (and (b) would follow therefrom). Naturally, and particularly if one were seeking to avoid Spanish tax in consequence of the change, Hacienda (and subsequently, but for different reasons, the Registrar of Companies) would want to see evidence of the substance of such a change. Mere asseveration of the proposition would not do,

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[8] including the infamous "cuenta de enlace" - linking account - to show every movement between branch and head office, and hence effectively exposing the whole of the company's business to the scrutiny of Hacienda.

[9] There is no change proposed in the new draft Law.

and some demonstration that the PEM is genuinely in Spain would be necessary. Whilst the concepts of controlling and shadow directors are not enunciated in Spanish law and practice, it may be a significant impediment to a claim that the PEM is in Spain if one of these figures can be discerned and is resident outside Spain. In order adequately to support the claim of immigration therefore, it would be necessary to appoint fully empowered local management and effectively to disenfranchise the previous management.

Spanish company law[10] provides that any company which has its *domicilio* in Spanish territory "...shall be Spanish, and shall be governed by the present law whatever may be the place in which (it) may have been constituted". One of the various forms of management[11] provided for in Spanish company law would therefore be necessary. Inevitable also would be to devise a way to make this requirement fit with the company law of the jurisdiction of constitution.

The fact that Spain considers the company Spanish and governed by the relevant Spanish company law, gives rise to a whole range of complicated and expensive issues. The company must indeed comply with all those requirements, not merely of registration and reporting, but in its daily life after immigration and adoption of Spanish nationality. Equally, however, it will not cease to have the form it was born with. It may help the reader to learn that I have never found a set of circumstances where I have been able to conclude that the manoeuvre was realistically possible. It's a bit like trying to combine matter and anti-matter, I guess, though I've never achieved that either.

I have heard of at least one beneficial owner who, faced with such difficulties as rehearsed immediately above, elected for the company to "open an office in Spain", and installed some form of sham management. The company then proceeded to make resident company tax returns (nil payable, of course), which latter, it was claimed, was sufficient to demonstrate that Hacienda accepted that the company was resident. The manoeuvre patently fails on a number of grounds (and Hacienda may within five years reject the tax declarations on the basis of factual error - *error de hecho*). It is worth mentioning, however, since it does raise the question of whether there is some action one may take as a positive test of proof that the tax authority accepts the immigration as a fact. To my knowledge there is one test which applies to the immigration per se rather than to any consequence

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10 I refer to both the new *Ley de Sociedades Limitadas* (private company law) and to the *Ley de Sociedades Anónimas* (public company law), both of which (albeit in differently numbered articles) include precisely the same provisions.

11 The possibilities include a board of counsellors (*consejo de administración*) one or more of whom may be delegated to run the company (*consejero/s delegado/s*), a sole director (*administrador único*), two or more directors acting jointly (*administradores mancomunados*) or jointly and severally (*administradores solidarios*).

thereof. Stamp Duty law[12] provides that such a migration into Spain (either of place of effective management and/or of registered address) shall be taxable as an "operación societaria" (1% rate of duty - rather like capital duty) when neither the PEM nor the registered address were formerly in an EC country, or when in such a country a similar capital duty had not already been paid. Submission of a return for stamp duty is therefore available as a test against the Fisc of successful immigration of residence. If one were to achieve success (by which, strangely, I mean absolute acceptance of a proffered tax payment) the spectre of company law compliance inter alia, would once again be raised.

Taken all in all, I have some considerable doubt that, whilst theoretically possible, the migration of an offshore company into Spain is a practical planning tactic. One may, perhaps, achieve the saving of the 3% Levy ... but at what cost?

CONCLUSION

The 5% special tax was not a well-written piece of law. In my observation, it has produced an horrific - and some observers say insuperable - work-load for the Hacienda officers responsible for its management. Despite that, it is possible to conclude that, however clumsily, the tax has done its job if the principal aim was largely to stop the flow of (principally) Gibraltar company purchases of real property in Spain.

The major burden of work arising for Hacienda has been from the applications for exemption by way of declaration of beneficial ownership. The proposed 3% Levy cures that simply by removing that exemption. The Bill evidently benefits from experience gained in the administration of the 5% Tax, in that it confidently spells out the quite clear circumstances in which exemption will henceforth be available. The only area in which there remains any doubt of interpretation is in the issue of what constitutes the continual or habitual operation of a trade in Spain distinct from the simple holding or letting of the property. I expect this doubt to be removed by the publication of clear criteria in the Regulations (or the continuing in force of the present Regulations).

From the point of view of the taxpayer, things are a little different. The reduction of the rate of tax from 5% to 3% will undoubtedly bring some relief. On the other hand, the exclusion of the exemption for declaration of beneficial ownership brings with it the need for new examination, new decisions, and probably new expense. Let us hope that the legislators now leave well alone, and that the tax administrators behave more responsibly in the operation of the 3% Levy than they did with the 5% Tax.

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12 *Impuesto sobre Tranmisiones Patrimoniales y Actos Juridicos Documentados* (ITPyAJD) or, for short, just ITP.