SPANISH TAX IMPLICATIONS OF NONRESIDENT PRIVATE INVESTMENT IN SPANISH REAL ESTATE

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INTRODUCTION

As global stock markets remain erratic and interest rates stay low, the Spanish real estate market has become an attractive investment opportunity for those in search of high-quality real property at reasonable prices. Major cities, such as Madrid and Barcelona, and some coastal areas have experienced growing demand translating into rising prices. While price levels remain below those in comparable cities in other countries, institutional and private investors are taking notice.

For an investor planning an intricate structure to invest in Spanish real property, it is important to recognize that Spanish tax law adopts a substance-over-form approach when it comes to taxation. Tax plans devoid of sound commercial basis and adequate substance are at risk to challenge. To illustrate, corporate structures used in Spanish real estate investments may be challenged where a corporate entity that owns the real property or that finances its acquisition

- has entered into arrangements that keep it from being tax resident for income tax treaty purposes in the country where it is formed, or
- lacks sufficient economic substance, as it may be defined for this purpose.[1]

In any event, using a corporate structure to invest in real estate may be beneficial for certain taxes and not beneficial for other taxes. This is especially true for private investors acquiring residential properties. This article provides a brief summary of the main domestic tax consequences that arise during the investment cycle of nonresident private investment in Spain.

INDIRECT AND LOCAL TAXATION

The acquisition of new residential property is subject to V.A.T. at a rate of 10% and stamp duty at a rate ranging from around 0.5% to 2.0%, depending on the region where the property is located. If the property is acquired in a resale – *viz.*, the purchaser is not the first owner – the purchase will be exempt from V.A.T. but subject to real estate transfer tax ("R.E.T.T.") at a rate generally ranging from around 8% to 10%, again depending on the region and market value of the property; a lower tax rate may apply in some circumstances.

Property tax (*Impuesto sobre Bienes Inmuebles* or "I.B.I.") is calculated annually

[1] With respect to a private real estate structure held for personal use, no economic substance should be required. However, an arm's length rental payment should be made by the individual living in the property to a corporation that owns it.

on the property's cadastral value, which is assigned by the local authority and is generally lower than the acquisition or market value. I.B.I. is generally nominal and is paid to the local town.

INCOME AND CAPITAL GAINS TAX

For periods when the property is not leased out, nonresident individuals are subject to an annual nonresident income tax at a rate of 24% on imputed income, which is generally equivalent to 1.1% (or 2.0% in some cases) of the cadastral value. If the property is leased out, nonresident income tax will apply on the gross rental income. The 24% rate is reduced to 19% for residents of other E.U. Member States, as well as residents of Iceland and Norway. Residents of these countries can also deduct expenses so as to be taxed on a net income basis.

Entities that are resident in a tax haven[2] and that hold Spanish real estate are subject to a special 3% annual tax on the cadastral value of the property (or the value established for wealth tax purposes, if cadastral value is unavailable).

When properties are sold or transferred by nonresidents, a 19% tax is applied on any capital gains. In such cases, the buyer withholds 3% of the total consideration as payment on behalf of the nonresident seller. If this withholding exceeds the final tax amount owed, the nonresident can request a refund.

The withholding tax also applies to transfers of shares in companies located in a tax haven whose assets are mainly composed of Spanish real estate, whether directly or indirectly.

If the property being sold qualifies as the habitual abode of the taxpayer, the capital gain may be exempt from tax if he or she is a tax resident of Spain, another E.U. Member State, Iceland, or Norway, and if other specific requirements are satisfied. For the property to be considered the seller's habitual abode, the seller must generally have lived there for at least three years, except when marriage, divorce, or employment reasons required a change of domicile.

When urban property is sold or transferred, the increase in value of the land is subject to a tax known as *plusvalía municipal*. The amount payable depends on criteria such as the cadastral value and the number of years the property has been held. The tax is paid by the seller to the local town.

WEALTH AND INHERITANCE TAXES

Wealth tax is payable on the value of assets located in Spain, less Spanish liabilities. Nonresidents are subject to general tax rules, while residents of Spain or another E.U. Member State may be subject to the rules applicable in the region where the property is located. Madrid, for example, grants a complete rebate on wealth tax to its residents.

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[2] See the list of tax haven countries or territories as established by Royal Decree 1080/1991, as amended. The list of tax haven countries in relation to Spain is published in a special edition of *Insights*, "Outbound Acquisitions: Holding Companies of Europe – A Guide for Tax Planning or a Road Map for Difficulty?" at page 114.

Wealth tax applies annually at progressive rates ranging from 0.20% to 2.75%, which is the marginal rate for net wealth exceeding €10.7 million. For E.U. residents, the applicable rules and tax rates may differ slightly depending on the region in which the property is located. The first €700,000 of net wealth (€500,000 in some regions) are generally tax exempt. Also exempt is the first €300,000 of the taxpayer's habitual abode. This amount varies depending on the region.

For wealth tax purposes, the tax base for real estate will be the greater of

- the consideration paid for the property,
- the cadastral value, and
- the value assigned by the authorities for other tax purposes.

Debt financing can reduce the net wealth base, resulting in lower effective taxation. This will be the case only if the loan proceeds are used to acquire or improve the property and not to finance other investments.

For inheritance tax purposes, the fair market value of real property on the transfer date is taxed at progressive rates of up to 34%. Effective taxation depends on several factors, including an E.U. resident's ability to apply the rules of the region where the property is located or where the deceased was resident. Again, the tax base can be reduced if a loan has been used to acquire or improve the property.

CORPORATE STRUCTURES

Aside from the benefits of increased privacy and limited liability, property ownership through a corporate structure can offer tax advantages. Those advantages are available only if the structure has appropriate substance and was established mainly for commercial purposes, not merely for tax reasons related to holding the real estate.

In terms of indirect taxation, if the property is acquired by a Spanish company during the course of conducting an appropriate business – *e.g.*, the company owning the property is engaged in real estate development activities and meets other criteria – R.E.T.T. may apply at a low rate. Alternatively, R.E.T.T. may not apply at all if the V.A.T. exemption on second or subsequent acquisitions is waived and the seller is registered for V.A.T. purposes. Such purchases would be subject to stamp duty and V.A.T. through a self-assessment mechanism, and V.A.T. may be fully or partially relieved. In comparison, R.E.T.T. leads to higher acquisition costs.

The acquisition of more than 50% of the shares in a Spanish or foreign company could be subject to indirect taxation in the form of R.E.T.T. or V.A.T., if Spanish real estate directly or indirectly comprises at least 50% of the fair market value of the target company's assets.

In relation to capital gains taxation, several double tax treaties concluded by Spain grant exclusive taxing rights to the investor's country of residence. Most of Spain's treaties follow paragraph 4 of Article 13 (Capital Gains) of the O.E.C.D. model tax convention,[3] meaning that taxation rights are generally granted to the country in

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[3] O.E.C.D., *Model Tax Convention on Income and on Capital: Condensed Version 2014*, (Paris: O.E.C.D. Publishing, 2014).

which the underlying real estate is located. In relation to wealth taxation, nonresident individuals may not be shielded from Spanish wealth tax even if the Spanish real estate is held through a Spanish or foreign corporate structure. For example, Spanish wealth tax is applicable to individuals who reside in Russia, France, Germany, or the U.K. that directly or indirectly own Spanish real property.

Entities resident in a tax haven or other low-tax jurisdiction whose assets are mostly comprised of Spanish property can be deemed tax resident in Spain. Likewise, the right to tax capital gains arising from sales of shares in real-estate-rich companies is rarely granted to the country of residence of the ultimate investor or the transferor of the Spanish or foreign shares.

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If the property is owned through a corporate structure, and Spain retains the right to imposed wealth tax on the shares in a company that holds mainly real property, the tax basis for wealth tax purposes will either be the net equity value of the company reported on financial statements reviewed by a statutory auditor or the highest of the following three values:

- The net equity value
- The nominal value of the shares
- The value derived when the average profits or losses of the previous three years are multiplied by a factor of five

Debt obligations incurred to finance the investment typically reduce the equity amount and interest on those obligations reduce the profit and losses during the three-year period. In either event, the effective taxation under the wealth tax regime would be lowered.

For income tax purposes, E.U. residents and residents of Iceland and Norway are entitled to deduct expenses directly linked to the income generated from the real property. As mentioned above, those residents may be subject to a 19% tax rate on net income. If the property is held through a Spanish entity, taxation on net income would be at a rate of 25% and withholding tax would likely apply to distributions. Conversely, if the property is not leased out and is held by a Spanish company, the imputed taxable income in relation to individuals – generally 1.1% of the cadastral value mentioned earlier – would not apply. The *plusvalía municipal* will only apply to gain derived from the direct sale of real property. This tax does not apply to gain on the sale of shares of the company.

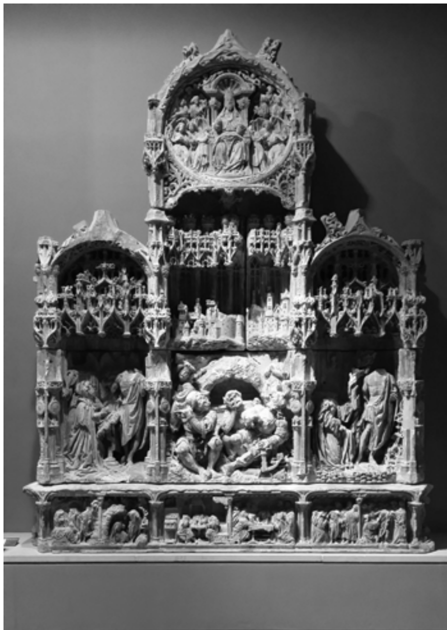
As mentioned above, the transfer of Spanish shares to heirs would be subject to inheritance tax at progressive rates of up to 34% of their fair market value. Again, effective taxation could be reduced by a debt obligation incurred by the Spanish company, provided that the proceeds of the debt obligation were used to finance the real estate investment. In comparison, the transfer of shares in a foreign company may escape Spanish inheritance taxation under certain circumstances.

Regarding inheritance planning, trusts are not recognized under Spanish law and Spain does not adhere to the Hague Convention of July 1, 1985 on the Law Applicable to Trusts and on Their Recognition. Consequently, the use of a trust to hold real property may cause problems from a practical legal and tax standpoint. Relatively little jurisprudence and doctrine exist regarding the taxation of trusts, resulting in uncertainty. The Spanish Tax Authorities (*Dirección General de Tributos*) have

issued rulings to taxpayers indicating that trusts generally should be disregarded for Spanish tax purposes and that transactions should be treated as if taking place directly between the settlor and the beneficiaries. In any event, trusts should be analyzed on a case-by-case basis.

CONCLUSION

In light of recent increases in the value of Spanish real property, acquisition tax planning is again of interest to potential investors from outside Spain. While income taxation of gains may not be reduced through structure planning, inheritance tax and wealth tax may be reduced through the use of a foreign corporation that is based in a tax treaty jurisdiction. The corporation must have economic substance. No matter how defined, if substance does not exist, expected tax benefits may be ephemeral.



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