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PRACTITIONERS' CORNER

Tax Implications of Nonresident Private Investment in Spanish Real Estate

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In this article, the author discusses the tax consequences for nonresidents investing in Spanish real property via corporate structures.

As global stock markets remain erratic and interest rates stay low, the Spanish real estate market has become an increasingly attractive investment destination for those in search of bargains on good-quality real property stock. Major cities, such as Madrid and Barcelona, and some coastal areas are already experiencing increased demand and rising prices. The Spanish property market has experienced a turnaround, and institutional and private investors are taking notice.

The Spanish tax system follows a substance-over-form approach; tax schemes are likely to be challenged when they lack a sound commercial basis and adequate substance. Corporate structures used in Spanish real estate investments could be successfully challenged if:

- the entities are not resident in their respective countries for double tax treaty purposes;
- they lack sufficient substance;
- they lack sound, properly evidenced and documented commercial or business justifications; and
- their main purpose is merely to reduce or avoid Spanish taxation.

Using a corporate structure to invest in real estate may not be beneficial in some cases, especially those involving private investors and residential properties. This article provides a brief summary of the main domestic tax consequences that arise during the investment cycles of nonresident private investors in Spain.

Indirect and Local Taxation

The acquisition of new residential property is subject to VAT at a rate of 10 percent and stamp duty at a rate ranging from around 0.5 to 2 percent (the applicable rate depends on the region where the property is located). If the property has been transferred before, the purchase will be exempt from VAT but subject to real estate transfer tax (RETT) at a rate generally ranging from around 8 to 10 percent (again, the applicable rate depends on the region and market value of the property, and a lower tax rate may apply).

Property tax (IBI, its Spanish acronym) is calculated annually on the property's cadastral value, which is assigned to it by the local authority and is generally lower than the acquisition or market value. IBI is generally nominal and is paid to the local town hall.

Income and Capital Gains Tax

For periods when the property is not leased out, nonresident individuals are subject to annual nonresident income tax at a rate of 24 percent on imputed income, which is generally equivalent to 1.1 percent (or 2 percent 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 percent rate is reduced to 19 percent for residents of other European Union member states as well as Iceland and Norway. Residents of these countries can also deduct expenses so as to be taxed on a net income basis.

Entities resident in a Spanish-listed tax haven that hold real estate in Spain are subject to a special 3 percent 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 percent tax is applied on any capital gains. In such cases, the buyer withholds 3 percent 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 Spanish-listed 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 is a tax resident of Spain, another EU 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 a 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 hall.

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 EU member state may be subject to the rules applicable in the region where the property is located (Madrid grants a complete rebate on the wealth tax to its residents, for example).

Wealth tax applies annually at progressive rates ranging from 0.2 to 2.75 percent (the marginal rate for net wealth exceeding €10.7 million). For EU 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) is generally tax exempt.

The taxpayer's habitual abode is also exempt from tax up to €300,000 (this amount also varies depending on the region). The tax basis for real estate will be the greater of the:

- consideration paid for the property;
- cadastral value; or
- 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, however.

For inheritance tax purposes, the fair market value of the property on the transfer date is subject to tax at progressive rates of up to 34 percent. Effective taxation depends on several factors, including EU residents' ability to apply the rules of the region where the property is located or where the deceased was resident. Again, the tax basis would also be reduced if a loan was used to acquire or improve the property.

Corporate Structures

Aside from the benefits of increased privacy and limited liability, property ownership via a corporate structure (whether in Spain, abroad, or both) can offer tax advantages. Those advantages, however, 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 was acquired by a Spanish company in conducting an appropriate business, RETT may apply at a low rate (for example, if the company is engaged in real estate development activities and meets other criteria) or may not apply at all if the VAT exemption on second or subsequent acquisitions is waived and the seller is also a VAT taxpayer. Such purchases would be subject to stamp duty and VAT through a self-assessment mechanism, and VAT may be fully or partially credited (while RETT would lead to higher acquisition costs).

The acquisition of more than 50 percent of the shares in a Spanish or foreign company could be subject to indirect taxation in the form of RETT or VAT if, directly or indirectly, Spanish real estate makes up at least 50 percent of the FMV of the company's assets.

In relation to capital gains and wealth taxation, a minority of double tax treaties concluded by Spain grant taxing rights to the investor's country of residence only. Most of Spain's treaties follow the OECD model tax convention, however, meaning taxation rights are generally granted to the country in which the underlying real estate is located. Russian, French, German, or U.K. resident individuals, for example, may not be shielded from Spanish wealth tax even if they hold the Spanish real estate through a Spanish or foreign corporate structure. Entities resident in a Spanish-listed tax haven (or some other low-tax jurisdiction) whose assets mostly comprise Spanish property can also 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.

If the property is owned through a corporate structure, and Spain has the taxing rights to shares in companies that hold mainly real estate, the tax basis for wealth tax purposes will be the net equity value of the company, if it produces financial statements reviewed by a statutory auditor, or the higher of the:

- net equity value;
- nominal value of the shares; or
- value resulting from multiplying by 5 the average profits or losses of the previous three years.

Any loans to the company used to finance the investment would reduce the equity amount, and effective taxation would be lower as a result.

For income tax purposes, EU residents can deduct expenses directly linked to the income generated. As mentioned above, those residents may be subject to a 19 percent 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 percent 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 mentioned earlier in relation to individuals (generally 1.1 percent of the cadastral value) would not apply. The *plusvalía municipal* will apply only on the sale of the property, rather than shares of the company.

For inheritance tax purposes, the transfer of Spanish shares to heirs would be subject to tax at progressive rates of up to 34 percent of their FMV. Again, effective taxation would be reduced by any debt held by the Spanish company that was used to finance the real estate investment. The transfer of shares in a foreign company may escape Spanish inheritance taxation under some circumstances.

Regarding inheritance planning, trusts are not recognized under Spanish law, and Spain did not adhere to the Hague Convention of 1 July 1985 on the Law Applicable to Trusts and on Their Recognition. Trusts are an alien institution under Spanish law, and this may cause problems from a practical legal and tax standpoint. Since there is relatively little jurisprudence and doctrine on the Spanish tax treatment of trusts, using trusts in Spain is shrouded in uncertainty. The Spanish tax authority (Dirección General de Tributos) has issued rulings to taxpayers indicating that trusts should generally 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. ◆