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by Carlos Gabarró

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In this article, the author answers some common questions about the Spanish tax treatment of trusts and private interest foundations as widely acknowledged cross-border structures for wealth preservation and estate planning.

It is common for some families to use wealth preservation and estate planning strategies. In many instances, trusts are established in common law jurisdictions or through private interest foundations (PIFs) in civil law jurisdictions. When investments are held directly or indirectly in Spain or a Spanish tax resident is related to any such structures, tax questions arise. This article will provide high-level answers to some of the most common questions posed by investors about Spanish tax implications of trusts and foundations.

Spanish Law and Trusts

Spanish law doesn't recognize trusts. In fact, because trusts generally lack legal personality in the jurisdiction in which they were created, the Spanish Civil Code won't recognize them as legal entities. And except in rare circumstances, assets ownership split that is sometimes recognized when a trust is created in a common law jurisdiction would not be recognized under Spanish law.

Spain doesn't adhere to the 1985 Hague trust convention. Trusts aren't recognized under Spanish law and may in some instances raise legal issues when they include Spanish investments or transactions.

Other than references to the tax treatment of trusts found in double tax treaties Spain holds with common law countries, Spanish tax authorities view trusts as disregarded (fiscally transparent) entities, and trust-related transactions are viewed as transpiring directly between the settlor (or grantor) and the beneficiaries.

Tax Implications for a Spanish Tax Resident

The tax authorities have been vague and contradictory in their interpretation of rulings issued to taxpayers, although they usually treat trust-related transactions as taking place directly between settlor or grantor and beneficiaries. Careful consideration should therefore be given to the trust's contractual arrangements.

When dealing with Spanish tax residents, the trust's fiscal transparency and flow-through tax treatment should be considered for personal income tax, wealth tax, and inheritance and gift taxes.

A Spanish tax resident settlor's or grantor's contribution of assets to a trust should not be seen as an alienation or transfer of assets. That remains the case as long as the settlor or grantor is the beneficiary, or a future condition must be met before the beneficiaries acquire rights to the trust's assets. The settlor or grantor is considered to own the investments held in the name of the trustees, and any income will be directly attributed to the settlor or grantor, who will then be taxed accordingly (similar to the tax treatment of a U.S. grantor trust).

A Spanish tax resident beneficiary entitled to the trust assets is subject to inheritance or gift taxation as if the assets had been received from the settlor or grantor. An individual Spanish resident is taxed on assets and rights acquired by

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inheritance or gift, regardless of the location of those assets or rights. But if the recipient is not resident in Spain, inheritance and gift tax applies only to assets or rights located in Spain, and the beneficiary would be the one to own the investments and report taxable income.

Specific Reporting Requirements

There are other reporting obligations for trusts besides those on ordinary tax returns. The ultimate beneficial owner must be reported when holding Spanish investments via a declaration to foreign investment authorities as well as a notarized deed declaration and a specific declaration filed in the Commercial Registry with the financial statements when holding a Spanish company.

Spanish tax residents should review whether they are required to file an annual foreign assets declaration via Form 720 reporting specific asset categories held abroad. Failure to do so, or an inaccurate filing, could lead to heavy penalties.

Private Interest Foundation Recognition

Under Spanish law, foundations should have a general and social purpose and cannot be set up for private purposes. According to articles 2 and 3 of the Spanish Foundations Act, foundations are nonprofit organizations that, by the will of their founder, follow objectives of a general interest.

For foreign PIFs, article 9.11 of the Spanish Civil Code establishes that applicable law is determined by the PIF's geographic origin, governing capacity, constitution, representation, operation, transformation, dissolution, and extinction of the PIF. Therefore, a foreign foundation's legal personality attributed by the laws of its jurisdiction of formation is recognized under Spanish law. It is a legal entity separate from its founder and beneficiaries, and its legal personality affects the Spanish tax treatment of the PIF's Spain-related transactions.

Major Tax Implications for PIF Transactions

Contributions to the PIF, as a separate legal entity, are treated as an alienation or transfer of assets, and any capital gain would be subject to Spanish taxation at the transferor level. A resident individual would be taxed at 19 to 23 percent on capital gains, while a resident company would be taxed at the corporate rate of 25 percent. The PIF would be subject to a 19 percent tax on the value of the assets or rights located (or that can be exercised) in Spanish territory, unless a double tax treaty provides taxing rights only to the PIF's tax residence jurisdiction. Conversely, distributions by the PIF to its Spanish tax resident beneficiaries are subject to gift tax for individuals or corporate income tax for corporate taxpayers.

According to most rulings issued by the Spanish tax authorities, a beneficiary who is a private individual resident in Spain that receives a distribution from a PIF is subject to the detrimental gift tax applicable to gifts between unrelated parties.

While gifts between family members may benefit from reductions or low rates (depending on their region of residence within Spain, these can be relatively beneficial), the gift tax is still subject to multipliers that increase as the degree of kinship and the wealth of the recipient increases. This, together with the tax rates' progressivity, may lead to a high gift tax rate for some resident individuals. A beneficiary that is not a Spanish tax resident at the time of receiving the distribution will be subject to gift taxation only on assets or rights located in Spanish territory.

Wealth Tax Applicability

Wealth tax applies to economically valuable assets or rights held by an individual taxpayer as of the date of accrual (December 31). Hence, if the resident founder or the beneficiaries do not own any PIF assets or rights as of this date, no tax applies.

A PIF is an "orphan" entity (that is, it has no shareholders), so the founder or the beneficiaries hold no interest, and there is no tax-triggering event. However, if any person holds rights in PIF investments while a tax resident of Spain, wealth tax would apply.

Taxation of a Certificate of Participation

If a Spanish tax resident holds a certificate of participation in PIF investment-generated profits (as is common in some European PIF structures), the fair market value of the certificates would be subject to wealth taxation.

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While the certificate of participation-generated income may be taxed in a similar manner as dividend income (19 to 23 percent tax), careful consideration should be given to Spanish-controlled foreign corporation rules (international fiscal transparency regime). Under CFC rules, a resident taxpayer would be required to integrate some types of income generated by a foreign entity when (with some exceptions) the person directly or indirectly, solely or together with close family members or with related entities, holds at least a 50 percent participation interest in the profits of a foreign entity. Absent contrary proof, CFC rules would automatically apply when the PIF is resident in a Spanish-listed tax haven. Likewise, CFC rules should be observed when the beneficiaries of the PIF are resident in Spain.

All the above should be carefully considered. A case-by-case review should be performed, and other questions may arise. Trusts and PIFs are unrecognized by the Spanish legal system and might create uncertainties for both taxpayers and tax authorities in an audit. ■

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