The Spanish Tax Reform – How does it affect non-resident expats?

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The Spanish Government has recently released two draft Bills with important amendments to the existing personal and corporate tax regime, of particular relevance to non-resident citizens with Spanish properties.

The effects of the amendments will vary depending on how the Spanish properties are held and the benefits of any relevant Double Tax Treaty. These holding structures may range from direct ownership of the property by the individual, to sophisticated triple tier corporate structures.

Expats holding Spanish properties directly will, in general terms, benefit from the proposed amendments – the Spanish tax charge on the eventual capital gain will be reduced from the current 35% to 18%. On the down side, they will still be exposed to an annual Spanish income and wealth tax charge and, more significantly, to Spanish inheritance tax on an eventual inheritance or donation of the property, generally in the range of 24% to 34%.

Non-resident taxpayers holding Spanish properties through a Spanish corporate vehicle will also be affected by the draft Bills, particularly where the company is a Passive Investment entity ("sociedad patrimonial"). Under current proposals, this regime will be abolished for accounting periods starting on or after 1 January 2007. Passive Investment companies will no longer benefit from the reduced 15% corporation tax rate on long term capital gains; they will be taxed under standard Spanish corporation tax rules and rate. The standard rate will be gradually reduced from the existing 35% to 30% in 2011.

If the shares in the Spanish corporation are directly held by a non-resident individual and the disposal of the property is arranged as a share transfer, the Spanish tax charge will be reduced to 18% from the current 35%. On the down side, the individual will still be exposed to an annual Spanish wealth tax charge and an eventual Spanish inheritance tax liability.

The draft Bills will also have important implications for non-resident taxpayers who own Spanish properties through offshore corporate vehicles, in single, double or triple tier arrangements. Proposals in the Bill include bringing into the Spanish corporate tax net all vehicles domiciled in tax havens and zero tax jurisdictions, where the underlying assets mostly consist of Spanish properties and rights.

Other measures include provisions enabling the Spanish tax authorities to use the underlying properties to secure payment of Spanish taxes on direct or indirect transfers of ownership at any tier level, and the application of deemed mark-to-market values on share disposals and transactions between related parties.

Non-resident individuals with offshore structures will also need to review their potential exposure to other personal taxes. The Spanish tax authorities are increasingly arguing that offshore entities holding Spanish properties are deemed Spanish located assets for tax purposes – and therefore subject to Spanish inheritance tax on transfers by reason of death or donation.

The reform proposals also include some important amendments in terms of tax compliance, including the obligation to appoint a tax representative in Spain in most cases involving non-resident individuals and corporations with direct or indirect investments in Spain.

It is still too early to plan ahead in any meaningful detail; the Bills are on their draft stages and will be subject to changes along their approval process by the Spanish Parliament. However, there already are some preliminary planning ideas worth exploring. Non-resident individuals negotiating direct purchases of Spanish properties should consider financing the acquisition through a mortgage to reduce their future Spanish wealth and inheritance tax exposure. Expats with Spanish Passive Investment entities should consider ways to step up the base cost of the properties while the regime is still applicable.

So how may UK residents owning Spanish property be affected? If they own the property direct the fall in the rate of capital gains tax in Spain is good news. Any gain will also be liable to UK capital gains tax with credit for the Spanish tax paid and the minimum UK rate is 24%. Passing the property on is still an issue as the UK and Spanish law and tax is very different but there are ideas.

The general UK advice for some time now has been to avoid holding Spanish property via a company, Spanish or otherwise as the UK tax implications can be serious. However, many people have acquired shares in property owning companies because the price was better and/or Spanish taxes were avoided and/or they were told to.

The reform is aimed at increasing Spanish tax revenues from real estate transactions. Consequently, an eventual surge of Spanish tax audits on property holding structures will come as no surprise – a good reason why expats should perform a Spanish and UK law and tax risk review of their structures so that changes can be made in the coming months.

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