The Spanish 2007 Tax Reform

Main Implications for International Private Clients

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1. The Spanish 2007 Tax Reform: Overview

The Spanish tax framework has been substantially modified following the enactment of the Tax Reform Acts, Ley 35/2006 and Ley 36/2006, generally with effect from 1 January 2007. The main tax implications for International Private Clients are as follows:

1.1. Corporation Tax

1.1.1. Offshore structures and tax havens

• Companies domiciled in zero tax jurisdictions and/or tax havens may be deemed Spanish tax resident if the majority of their assets, directly or indirectly held, are located or enforceable in Spain and/or if their main activities are performed in Spain => Vulnerable structures

•Scope for overrule: proof of effective management and control at company's domicile and existence of valid economic reasons other than mere asset management

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•Tax havens: closed list of jurisdictions listed in Real Decreto 1080/1991

•Zero tax jurisdictions: non-Treaty jurisdictions with no analogous Income Tax, Corporation Tax and Non-Resident Tax regimes

- "Analogous": extent of application

•Corporation tax implications of becoming resident:

- Corporation tax on worldwide income and gains
- More generous tax allowability of costs and expenses vs. non-resident tax regime
- Possibility to apply tax exemption on dividends received from Spanish entities

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1.1.2. **Transfer pricing**

- Shift in mark-to-market transfer pricing adjustments: now the responsibility of the taxpayer both for corporation tax, income tax and non-resident tax purposes

- Accepted valuation methods and allowability of management fees

- "Secondary adjustments":
  - A transfer pricing adjustment will be deemed a dividend distribution/contribution to capital where the counterparty is the shareholder
  - If the counterparty is not a shareholder: "constructive loan"?

- Specific documentation requirements: pending statutory approval but of particular relevance: penalties of up to €1,500 per missing, false or inexact document and up to € 15,000 per missing, false or inexact set of documents, on top of penalties for overdue taxes

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1.1.3. **Corporation tax rates**

- The general corporation tax rate will be 32.5% and 30% for periods commencing on or after 1 January 2007 and 1 January 2008 respectively. Small companies rate will be 25% for taxable profits up to € 120,202.41, 30% on the balance for periods commencing on or after 1 January 2007. These rates will also apply to Spanish permanent establishments of foreign corporations

1.1.4. **Abolition of the Passive Investment Company regime**

- The Passive Investment Company regime will be abolished for periods commencing on or after 1 January 2007, except for companies resident in the Basque region

- Companies will become taxable under general corporation tax rules

- Income and gains pending taxation arising from income tax/corporation tax mismatches will become taxable in the first period commencing on or after 1 January 2007

- Income and gains already assessed will not be double taxed under general corporation tax rules

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• Dividends out of "PIC" reserves will remain exempt from income tax - but may continue to have adverse wealth tax implications. "PIC" reserves will also be taken into account to compute the base cost of the shares for capital gains purposes on an eventual transfer

• Transitional tax relief on dissolution and liquidation of Passive Investment companies:

- Applicable to companies with Passive Investment status for all periods commencing on or after 1 January 2005. Dissolution and liquidation resolutions must be validly adopted within six months during the first period commencing on or after 1 January 2007. Liquidation must be effectively achieved within the following six months

- The tax benefits include Stamp Duty exemption, exemption on Municipal Tax on Real Estate transfers, corporation tax exemption and, in general, holdover relief for income tax purposes

• Transitional "PIC" companies will be subject to an 18% rate on long term capital gains, 40% on any other taxable profits. Abatement relief on pre-1994 shares will not be available to "PIC" companies under tax protected dissolution/liquidation procedures and to assets received on liquidation

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1.2. Income Tax

1.2.1. Investment income

- Under the new income tax provisions, as a general rule investment income, including interest, dividends and capital gains, will have the nature of "savings income" and taxed at an 18% flat rate, except certain items of income including:
  - Dividends received from International Holding companies ("ETVE" companies)
  - Interest received from related entities
- Abolition of the 40% abatement relief applicable to investment income with a period of generation of over 2 years
- Tax exemption on dividend income up to € 1,500. Domestic double tax relief provisions are abolished

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1.2.2. **Life Insurance Proceeds**

- Proceeds payable as a capital sum will no longer benefit from 40% abatement relief. Certain grandfathering provisions will mitigate the exposure for pre-20/1/2006 policies

- Proceeds payable as temporary/life annuities will be subject to tax by application of the relevant tax tables which take into account the duration of the annuity and the age of the beneficiary, respectively. This treatment will also be applicable to policies payable as a capital sum or as a temporary/life annuity, at the taxpayer's option, when the individual opts for the latter

1.2.3. **Business Income derived from Real Estate activities**

- The activity of real estate letting will continue to be deemed a business if carried on in separate business premises and engages at least one full-time employee

- The purchase and sale of real estate has been excluded from the above and will consequently be assessed as a business based on general substance rules => important uncertainties on a substantial issue

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1.2.4. **Capital Gains: abatement relief on pre-1994 assets**

•So far, gains on pre-1994 assets have been abated at a rate of 11.11%, 25% and 14.28% per annum up to 31 December 1994 on disposals of real estate, quoted shares and other assets, respectively. This has meant total income tax exemption for pre-1986, 1991 and 1988 assets, respectively. Abatement relief is also applicable for Non-Resident Tax purposes

•Abatement relief will be “frozen” for disposals taking place on or after 20 January 2006:

- •In general, the gain will be prorrated on a daily basis. The portion of the gain generated up to 19 January 2006 will continue to enjoy abatement relief. The portion of the gain generated on or after 20 January 2006 will have the nature of savings income and will not benefit from pre-1994 abatement relief

- •Entitlement to abatement relief on quoted shares and units in investment funds will be calculated by reference to special provisions that take into account the value of the asset for 2005 wealth tax purposes

• As a side issue, capital gains derived from the disposal of the habitual residence of the taxpayer will be tax exempt for taxpayers over 65 or impaired

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1.2.5. **Tax rates**

- Savings income and losses other than capital gains and losses will offset. Capital gains and losses will also be offset. Losses may be carried forward 4 years. The sum of net taxable savings income other than gains and net taxable capital gains will be taxable at a flat rate of 18%

- All sources of general income may be offset, except for certain capital gains and losses specifically treated as general income (eg lottery wins). General income will be taxed by application of the progressive tax tables, ranging from 24% (on taxable income up to € 17,360) to 43% (on taxable income in excess of € 52,360)

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1.3. Wealth Tax

1.3.1. Scope of wealth tax exemption on shares

The requirements to apply wealth tax exemption on shares continue to be as follows:

• The taxpayer must hold at least a 5% shareholding individually or 20% together with his/her qualifying family group

• The taxpayer or a shareholder of the qualifying family group must perform managerial services and derive a salary of more than 50% of his/her total employment, professional and entrepreneurial income for the year

• The company must be operating. A company will not be operating if for more than 90 days in any given period more than 50% of its assets are of a passive nature, excluding:

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- Shareholdings of 5% or over in operating companies, provided that the holding company has a reasonable level of business substance

- Passive investments not exceeding reserves generated as an operating company over the current and ten preceding years

• Wealth tax exemption may only be effectively applied on assets attached or deemed attached to the business of the company. So far, this computation was only performed at first-tier level and was the reason of many two-tier structures. From 1 January 2007, this restriction will be extended and will effectively bring to wealth tax non-business assets wrapped in corporate structures at second-tier level

1.3.2. **Joint income tax-wealth tax limitation mechanism**

In order to mitigate the impact of wealth tax on illiquid asset structures, the Spanish wealth tax legislation has a mechanism to reduce the wealth tax liability. This takes into account the taxable income for income tax purposes and overall income tax and wealth tax liabilities

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• From 1 January 2007, this mechanism will remain largely the same, and will continue to limit the wealth tax payable as follows:

  • In general, the joint gross income tax and wealth tax liability may not exceed 60% of the general taxable and savings income excluding capital gains on assets held for more than one year but including exempt dividends distributed by companies out of “PIC” reserves

  • Such cap may not exceed 80% of the tax payable by application of the wealth tax tables. Consequently the wealth tax payable will continue to amount to at least 20% of the tax payable as per the wealth tax tables

• This mechanism has become one of the key issues in terms of joint income tax-wealth tax planning, even more so as new anti-avoidance provisions have tightened the possibility to use two-tier structures to gain wealth tax exemption on passive portfolios. At best, it limits the marginal wealth tax rate to 0.5%. Tax planning strategies based solely on income tax may at worst raise the joint income and wealth tax liability to 60% of the individual’s income

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1.4. Inheritance Tax

•The tax reform Acts do not include specific amendments to the inheritance tax legislation

•The main indirect effects on inheritance tax include the treatment of offshore domiciled but deemed resident corporations as Spanish located assets

•The collection, and in some cases the power to legislate, of inheritance tax has been transferred to the Spanish regions ("Comunidades Autónomas"). However, in general the inheritance tax reforms increasingly adopted by many Spanish regions, mostly exempting from tax inheritances, and in some cases donations, in favour of descendants and spouses **do not apply to non-resident heirs and to heirs of non-resident deceased**. These are governed by the mainstream inheritance tax regulations which **do not exempt from tax** gifts and inheritances between spouses and/or descendants

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1.5. Non-Resident Tax

- Dividends paid to non-resident individuals up to € 1,500 per annum will be non-resident tax exempt provided that they are EU resident or resident in jurisdictions with effective exchange of information procedures in place:
    - Treaty countries
    - Countries with an exchange of information treaty to the extent that the level of exchange is expressly deemed satisfactory by the Spanish tax authorities
    - Exemption will never be applicable to tax haven residents

- Interest and capital gains on shares derived by EU residents will continue to be exempt from non-resident tax. Capital gains tax exemption will continue to be denied to shares in real estate companies and to substantial shareholdings (25% or more)

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• The definition of Spanish-source gains includes those derived from shares or rights in entities resident in a jurisdiction with no effective exchange of information procedures in place and whose main assets are Spanish located real estate. The new regulations include a provision whereby the disposal value of such assets for capital gains purposes will be calculated by reference to the market value of the underlying Spanish real estate at the time of disposal. The legislation also enables the Spanish tax administration to use the Spanish assets, including the underlying real estate, to secure payment of non-resident taxes due

- The general non-resident tax rate is lowered to 24% (25% up to 31 December 2006). Tax on investment income is raised to 18% (15% up to 31 December 2006). Tax on capital gains is lowered to 18% (35% up to 31 December 2006)

- Abolition of branch tax to Spanish Permanent Establishments of EU resident corporations, except for tax haven residents. The branch tax rate is raised to 18% (15% up to 31 December 2006)

- The payment on account of non-resident tax generally applicable to buyers of Spanish located real estate from non-resident sellers is lowered to 3% (previously 5%) on the disposal proceeds

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1.6. **VAT and Transfer Tax**

•From 1 January 2008, VAT grouping provisions will allow Spanish companies of the same group to file group VAT returns

• The tax reform contains amendments to the anti-avoidance rules concerning envelope schemes to avoid Transfer Tax on transfers of real estate. These amendments include the following:

- Inclusion of transfers of real estate through two-tier structures
- Computing shares held through related companies in order to arrive at the percentage of shareholding held in the real estate company
- Inclusion of indirect transfers of real estate through treasury stock-share amortisation schemes
- Extending the period of application of the anti-avoidance rules from 1 to 3 years from the date of contribution of the real estate to a company to the date of disposal of the shares

• The legislation includes a waiver of the anti-avoidance rules in certain cases relating to quoted shares and IPOs

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1.7. Double Tax Treaties

Although outside the scope of the Acts, it is worth noting that the bilateral negotiations for the amendment of the Spanish-Swiss Double Tax Treaty have concluded. This is now pending domestic Parliament approval. The scope of the amendments is mainly as follows:

•Withholding tax on dividends may not exceed 15%

•Dividends and royalties received on substantial participations (at least 25% held for at least 2 years) will be tax exempt provided that the paying company is subject to and not exempt from Spanish/Swiss corporation tax

•Withholding tax exemption on interest, provided certain requirements are met

•Certain amendments to the tax sparing clause on interest

•Introduction of an **exchange of information clause**:

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- The scope of the exchange of information provisions will be limited to verifying the correct application of Treaty provisions on taxes covered, verifying the correct application of domestic laws relating to taxes covered by the Treaty, in cases of holding companies, and to tax fraud relating to taxes covered by the Treaty where such conduct constitutes a criminal offence in both jurisdictions

- The exchange of information procedures will not lead to the obligation to adopt administrative procedures contrary to domestic legislation and practices, provide information that would otherwise not be available under the domestic law of the country requesting the exchange, or information protected by entrepreneurial, industrial, commercial or professional secrecy laws (but excluding banking secrecy laws in cases of tax fraud). "Fishing expeditions" will not be covered by the clause

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1.8. Compliance and responsibilities

- **Non-Resident Tax: Persons Joint and Several Liable**
  - The following persons will be deemed joint and severally liable for non-resident tax:
    - The payer
    - From 1 January 2007, the depositary or asset manager will be jointly and severally liable for any Spanish non-resident taxes due, where the owner of the asset is resident in a tax haven
- **Tax representatives**
  - Residents in jurisdictions with no effective exchange of information procedures in place and owners of Spanish located assets and/or rights, except quoted shares, will be obliged to appoint a tax representative. Failure to make an appointment will give rise to a € 6,000 penalty. In this event:

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• The Spanish administration may deem the depositary or asset manager as tax representative

• Notifications sent to the Spanish real estate property owned by the non-resident will be deemed validly made

• **Other responsibilities**

• The extent of the joint and several responsibility in certain cases will include penalties and interest on overdue tax

• The Spanish tax administration may lift the corporate veil and deem subsidiarily responsible for unpaid taxes, interest and penalties any subsidiaries controlled by the taxpayer, where the existence of such subsidiaries have contributed to creating a tax abusive or fraudulent scheme

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- **Other measures**

- Buyers and sellers of real estate, including rights thereon, will be obliged to state their tax identification number (“NIF”) in the corresponding public deed

- Public deeds of transfer of real estate, including rights thereon, will need to include details of all payment terms and manner of settlement

2. Main implications of the tax reform for non-resident International Private Clients

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2. Main implications of the tax reform for non-resident International Private Clients

2.1. Investors in Spanish real estate

The main implications of the tax reform Acts for non-resident investors in Spanish real estate are as follows:

- Effects of "tax impatriation" of assets directly or indirectly held by tax haven/zero tax entities: deemed residence provisions
    - Potential issues: corporation tax effects/potential wealth tax-inheritance tax exposures/residence issues of the ultimate beneficiary: "centre of economic interests" test
    - Potential alternatives include:
        - Company migration
        - Dilution of Spanish asset base

2. Main implications of the tax reform for non-resident International Private Clients

• Need to plan carefully how to structure the disposal of Spanish real estate wrapped in a corporate structure involving a jurisdiction with no effective exchange of information procedures, as the transaction will fall within the Spanish tax net on the basis of the market value of the real estate and this may be used to secure tax payment

• It is important to assess the impact of the new transfer pricing provisions on privately used residential properties owned through a corporate structure, to deal with:

  • Deemed income provisions for corporation tax purposes

  • The effect of secondary adjustments: deemed Spanish source dividends

  • Need to prepare and produce written back-up documentation on related party transactions

• The abolition of the Passive Investment company regime will no longer enable the application of the 15%/18% flat rate on long-term capital gains

2. Main implications of the tax reform for non-resident International Private Clients

- Need to review the possibility to extend the application of the "PIC" regime some months into 2007
- Taxpayers should assess the possibility to dissolve and liquidate "PIC" companies under transitional tax relief rules

- Real estate directly held by individuals will benefit from a considerable reduction in non-resident tax on the gain (18% vs 35%), plus a reduction in withholding taxes on disposal (3% on sale proceeds vs 5% up to 31 December 2006), but will continue to face wealth tax and inheritance tax issues
- Internal group reorganisations involving controlled entities with substantial Spanish real estate investments will need to be carefully assessed under the new anti-avoidance Transfer Tax rules
- Taxpayers will need to ascertain whether or not they will need to appoint a Spanish tax representative under the new provisions

2. Main implications of the tax reform for non-resident International Private Clients

2.2. Investors in Spanish financial markets

The main implications of the tax reform Acts for non-resident investors in the Spanish financial markets are as follows:

• EU resident individual investors in Spanish financial instruments will continue to benefit from certain tax benefits, including interest and capital gains tax exemptions. Dividend exemption will however be limited to € 1,500

•Investors in Spanish stock through Passive Investment companies will need to consider the issues stated in 2.1. above

• Non-EU resident investors will benefit from a reduction in capital gains tax (18% vs 35%) but will be affected by an increase in taxes on dividends (18% vs 15% but subject to Treaty relief)

• Investors in large Spanish portfolios through companies resident in tax-haven or zero-tax jurisdictions will need to assess their new exposure to corporation tax as deemed tax resident corporations and decide on what actions need to be taken to avoid such exposure

3. Main implications of the tax reform for Spanish resident International Private Clients

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3. Main implications of the tax reform for Spanish resident International Private Clients

3.1. Passive Investors

Spanish resident owners of passive structures (mainly real estate and financial portfolios) will need to consider in detail the impact of the reform on their taxes, including the following:

- Need to accommodate the overall structure to the new transfer pricing requirements, both in terms of documentation and in terms of pricing methods and secondary adjustment provisions

- Need to assess the position in terms of Passive Investment Companies owned by them, including actions towards extending the regime into 2007, the possibility to dissolve and liquidate under transitional tax protected mechanisms and potential company migration schemes to the Basque region

- It is important to check the effects of the new definition of business income as pertains real estate companies, to ensure whether or not these continue to have the nature of operating companies

3. Main implications of the tax reform for Spanish resident International Private Clients

• Passive investors will also need to assess their new exposures to tax on pre-1994 assets

• As regards wealth tax, passive investors will need to review their tax strategies, particularly as regards the following matters:

- The extent of efficiency of their double tier structures in view of the new anti-avoidance provisions. Monitor the potential impact of the new anti-avoidance provisions on transfer tax on any reorganisation required

- Maximise the tax efficiency of distributions of “PIC” reserves, with a correct balance between their income tax free status with the potentially negative effect on the joint income tax and wealth tax limitation mechanism

- Review of financial portfolios and shareholder remuneration policies, with the new streamlined 18% on savings income, previously only applicable to long-term capital gains, but combined with a tax efficient management of the joint income tax and wealth tax limitation mechanism

3. Main implications of the tax reform for Spanish resident International Private Clients

3.2. Entrepreneurs and shareholders in operating companies

As regards entrepreneurs and shareholders in operating companies, the main areas for review following the tax reform are as follows:

• Impact of the new transfer pricing provisions both in terms of documentation requirements and the effects of the new pricing methods and secondary adjustment provisions

• Review of policies pertaining to dividend distributions following the abolition of the domestic double tax relief provisions for income tax purposes

• Assessment of the impact of the revised abatement relief rules on pre-1994 assets

• Review of financial portfolios, with the new streamlined 18% on savings income, previously only applicable to long-term capital gains, but combined with a tax efficient management of the joint income tax and wealth tax limitation mechanism

3. Main implications of the tax reform for Spanish resident International Private Clients

• Detailed review of the wealth tax position, to ensure the application of wealth tax exemption and the impact of the new provisions on two-tier structures

•Assessment of the impact of the revised anti-avoidance transfer tax rules on any potential group reorganisation to accommodate the structures to the new tax reform rules

4. Avantia Family Office

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Avantia Family Office - Asesoramiento Fiscal Especializado is an independent professional Firm that provides national and international tax and legal services to our Private Client base since its incorporation in February 2005

Our Firm, led by Javier Estella, Patricia Garcia and Gabriel Pérez, has over fifteen years of relevant professional experience in the private client sector in Price Waterhouse (now PricewaterhouseCoopers) and Ernst & Young, as well as outstanding academic qualifications in Spain and the UK in the fields of taxation, legal counsel and business management

Our Private Client services are provided through a professional relationship built on trust, confidentiality and an integrated legal, tax and compliance approach, including Spanish and international taxation, as well as business and civil law issues which may affect the global wealth of our clients

4. Avantia Family Office

Our professional staff also coordinates with our clients' external financial and other advisors in relation to matters affecting their wealth, to ensure a seamless private wealth management that optimises investment returns while retaining independent tax and legal advice

Avantia Family Office - Asesoramiento Fiscal y Legal Especializado also has a full-time professional team, led and coordinated by Patricia Garcia, which provides international tax and legal private wealth services to both Spanish individuals with investments abroad and foreign citizens investing into Spain. Patricia is a Spanish practitioner with UK tax professional qualifications (ATII, 1992) and has held responsibilities over International Private Client matters for more than 12 years

Further information and details of our practice may be found at www.avantiafamilyoffice.com