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Client Briefing

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Relevant new measures in Spanish real estate taxation

On Tuesday, 30 October 2012, the Official State Gazette published Law 7/2012, of 29 October, which amends tax and budget legislation and adapts financial regulations in preparation for intensified actions to prevent and combat tax fraud ("**Law 7/2012**").

Given the great relevancy of the tax measures introduced in relation to the taxation triggered on the (direct or indirect) acquisition of real estate located in Spain, this Client Briefing is intended to briefly announce the main new issues and implications arising from the amendments to the law, which entered into force on 31 October.

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On the one hand, certain real estate transactions subject to Value Added Tax ("**VAT**") have seen a change of taxpayer, which from now on is the purchaser instead of the seller (by way of incorporating two new cases where the "reverse charge mechanism" applies at the time of determining the VAT taxpayer). In practice, this may have significant implications for the purchaser, in terms of saving the VAT financial cost.

On the other hand, concerning the indirect purchase of real estate assets (through the acquisition of companies), Article 108 of the Spanish Securities Market Law (*Ley del Mercado de Valores*) ("**LMV**") has been re-characterised to become an authentic anti-avoidance rule, since its objective approach – as set forth by the ancient wording– has been suppressed. Therefore, with the law's new wording, the acquisition of a controlling stake in a company whose assets mainly consist of real estate will not necessarily trigger Spanish Transfer Tax ("**Transfer Tax**").

The main features and aspects of the new tax measures introduced by Law 7/2012 are summarised below:

1 New events of VAT self-charge and potential avoidance of the VAT financial cost

It is important to note, first of all, that changes have been made recently to VAT regulations in an attempt to avoid situations in which it may not be guaranteed that the Spanish Tax Authorities will receive the VAT paid by the acquirer, in certain real estate transfers (for example, when the transferor is in an insolvency situation).

For this purpose, the number of cases permitted by law in which the "reverse charge mechanism" operates has been expanded to include those in which the acquirer of the property (and not the transferor) is the one who must charge itself (i.e. "self-charge") the corresponding VAT, without paying any amount whatsoever

to the transferor for this tax. Two new cases are now included[1] in which the acquisition of real estate is affected by the self-charging mechanism:

a) *Exempted transfers governed by Article 20, sections 20 and 22 of the VAT Law, provided that the taxpayer has duly waived the VAT exemption*

   In other words, this would apply to certain real estate acquisitions in which, where a VAT exemption applies, the acquirer decides, together with the transferor (both of them companies) to waive this exemption if certain requirements are fulfilled. In such cases, the scope of the self-charged VAT could include both (i) the transfer of rural lands not suitable for building on which are indispensable for the development of an agricultural exploitation or for certain public uses (section 20), as well as (ii) the second and subsequent transfers of buildings[2], including the lands on which they are built, when they occur after their construction or renovation is completed (section 22).

   This case is the one we consider may have greater practical implications, since it is very common in business for the parties to choose, when possible and after first waiving the exemption, to pay VAT on the sale and purchase of real estate, since this tax can generally be recovered, unlike Transfer Tax.

b) *Transfers done in enforcing a real estate security, assuming that the security is being enforced when the property is transferred, in exchange for either the total or partial cancellation of the secured debt or the obligation by the acquirer to cancel the debt*

   This includes, among other cases, any acquisition of real estate –provided that VAT does indeed apply to the transaction– taking place in court auction proceedings involving the enforcement of a mortgage guarantee, but also the surrender of property in lieu of payment if agreed by the parties (the acquirer being the creditor and the transferor the debtor) to cancel (in full or in part) a debt in favour of the acquirer.

By virtue of the above, it is worth mentioning that the new legislation may have a very positive impact for those companies acquiring a used property from another company (as may be the case of commercial or industrial premises or a hotel complex, etc.), transactions to which the parties usually choose to have VAT apply.

True, the acquirer company (as taxpayer through the reverse charge mechanism) must charge itself the corresponding VAT on the acquisition (normally at the rate of 21 %). However, this (self-charged) VAT amount will generally be deductible[3] in relation to the tax charge, for the exact same amount, to be included as VAT charged (to itself), when the acquirer makes the corresponding (monthly or quarterly) tax return and settlement. In this way, no VAT amount whatsoever would be payable (either to the transferor or to the Tax Authorities) on the real estate purchase.

This will undoubtedly have significant repercussions in terms of the financial cost, which has traditionally

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[1] Self-charging VAT was already established, prior to the approval of Law 7/2012, for real estate transfers done as a result of insolvency proceedings, and this case still applies.

[2] Unlike what occurs in the first transfers of buildings (i.e. handovers done directly by the promoter), in which VAT would be charged but not self-charged.

[3] Provided that the prerequisites established in VAT law are fulfilled.

had to be assumed by the company acquiring the property, depending on the time elapsing between the payment (to the transferor) of the VAT amounts and their effective recovery (by offset or deduction) from the Tax Authorities. Thus, for many real estate transactions, VAT financing will no longer be needed, which will undoubtedly simplify those transactions and reduce the costs for the acquirer[4].

2 Amendment of Article 108 of Spanish Securities Market Law

Pursuant to the wording in force until 30 October, Article 108 LMV implied that Transfer Tax arose from the acquisition of a controlling stake in a company having at least 50% of its assets in real estate located in Spain ("**Real Estate Companies**")[5]. In particular, Transfer Tax was assess at the tax rates applicable in each Autonomous Community where the properties were located (ranging from 7% to 10%) on their "fair market value", taking into consideration the percentage of control obtained (or increased) in the Real Estate Company.

Once the new wording is in force, Article 108 LMV is no longer a generally applicable rule ("objective rule") –it used to apply regardless of whether or not the properties were engaged in an economic activity, and regardless of any fraudulent intent the parties might have– and has been re-characterised as a provision actually intended to prevent tax fraud ("anti-avoidance rule"). Accordingly, the new wording of Article 108 LMV greatly limits its own application and in turn provides a choice, under certain circumstances, for VAT (a neutral tax for most companies) to be charged, instead of Transfer Tax.

In particular, amongst the new aspects, the following should be highlighted:

a) The effective application of Article 108 LMV will no longer necessarily accrue Transfer Tax; instead, the indirect purchase of real estate (i.e. the purchase of securities in Real Estate Companies) may be subject to VAT in certain cases.

b) Following the reform, in order for taxation to be levied by virtue of Article 108 LMV, it will be necessary that "*the transfer of securities constitute an attempt to evade payment of the taxes that should have been levied on the transfer of the real estate owned by the entities*".

That is, the application of this anti-fraud measure is made subjective, in such a way that Article 108 LMV will only apply when a party carrying out the sale and purchase of securities in Real Estate Companies is seeking to evade taxes that would have been charged on the transfer of the real estate in the event of a direct acquisition of said real estate.

For that purpose, a system of assumptions is established (which could of course be disproven by evidence to the contrary) to apply in those cases in which the assets of the acquired Real Estate Company (or, as the case may be, the assets of the Real Estate Company which is indirectly controlled by another company

4 In any event, the possibility of a certain transaction being subject to self-charged VAT, thus effectively avoiding the financial cost of the VAT, must be duly analysed on a case-by-case basis.

5 More specifically, taxable events include obtaining control over a Real Estate Company (generally, by acquiring more than 50% of its share capital) as well as increasing such control, which may take place at a later stage. Additionally, the transfer of securities may be taxed as well, when the latter were received as consideration for contributing real estate to a company, unless at least three years have elapsed between the date when the property was contributed and the date when the securities were transferred.

or companies) consists principally of real estate located in Spain which "*is not used for business or professional activities*".

Thus, in these cases, it is the taxpayer who bears the burden of proof and who, if applicable, will have to demonstrate that it did not acquire said securities with a view to committing tax evasion[6].

In conclusion, our tax system benefits in terms of tax justice with this change in legislation, while it also strengthens the capacity to attract investment in this sector, since undoubtedly the objective application of Article 108 LMV over years has on many occasions dissuaded investors (be they local or foreign) from making foreign investments, not only Spanish real estate, but also in other business sectors (companies carrying out industrial or hotel activities or even the generation of renewable energies) which are unlikely to get out of paying a high Transfer Tax.

However, the new legislation could be improved, from a technical point of view, and is subject to subsequent interpretation, given that, for the time being, certain questions arise that should be resolved soon:

- What taxes are included under tax evasion?
- How will one be able to demonstrate that a real estate asset is associated with a business activity in certain cases?
- How is the intent to evade taxes in a transaction acknowledged and what consequences does it have on other taxes?

Meanwhile, the new wording of Article 108 LMV is indeed a "good start", especially when the controversial previous wording had been a source of lawsuits, to the point where European Community authorities were beginning to question its compatibility with EU law.

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[6] In this regard, we understand that properly supporting and justifying sufficient economic reasons –such as the acquirer's intent to associate real estate to a business activity– should suffice in order to be able to except said assumption. However, considering the newness of the current wording and the fact that little time has passed since it entered into force, any opinion regarding the operation and interpretation of Article 108 LMV must remain subject to the practices which may soon be adopted in this regard by the various Tax Authorities (including any criteria for interpretation applied by the Directorate General for Taxation) and by the courts, as the case may be.

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This publication does not necessarily deal with all important issues, nor does it cover all aspects of the issues analysed, and it is not designed to provide legal or other kinds of advice.

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