

Art. 2195 of the Civil Code. It should be noted that this test is never met when the assets of the company whose participation is disposed of are predominantly represented by real estate other than (i) buildings whose construction and disposal constitutes the effective business activity of the company in which the participation is held or (ii) plant or buildings instrumental to the business activity of the company (e.g. the office where the business activity is carried out). Real estate leased to third parties under financial leasing contracts is deemed to be instrumental to the business activity whilst real estate leased under an operating lease contract does not qualify under the "business activity" test.

The disposal of participations in pure real estate companies is therefore not entitled to the participation exemption and is subject to IRES in full.

The business activity test is not required to be met by companies whose shares are listed in regulated markets and for companies whose shares are the object of a public offer for sale.

With regard to capital gains realized upon the disposal of participations held in companies whose sole or predominant activity is that of a holding company, the "tax residence" test (i.e. residence in a non-tax privileged country) and the "business activity" test must be verified with respect to the subsidiaries. Therefore, capital gains realized upon the disposal of holding companies may benefit from the participation exemption when the above two tests are met by the subsidiaries that represent the greater part of the holding companies' assets.

Subject to the requirements stated above, the capital gains realized upon the disposal of the (contractual positions of) silent partnership agreements that involve cash contributions only are completely exempt from corporate tax.

In conclusion, it may be said that the new regime is more favourable than the old one when the participation exemption applies. In this case it is more favourable also when the gains are subsequently distributed (as dividends) to individual shareholders. In fact, the combined taxation is not greater than the 12.5% or 18% IRPEF levied on individuals, whilst in the old regime the combined taxation was 34% (the IRPEF paid by the company realizing the capital gains, plus IRPEF suffered at the shareholder's level (see above)). In contrast, when the participation exemption does not apply, the new regime may become less attractive due to the fact that it has abolished the special regime whereby the capital gains, under certain conditions, could be subject to a substitute tax levied at the rate of 19%.

The new regime modifies the treatment of non-resident persons who realize capital gains upon the disposal of Italian participation in the sense that they are now subject to the same (new) regime provided for resident individuals (see above). In other words, the regime for non-residents, which was identical to the one governing resident individuals in the old regime, is now changed correspondingly. However, and as already explained, non-residents generally avoid Italian taxation by virtue of treaty and domestic exemptions, which remain unaltered under the reform.

## Spain

### Tax Changes: Thin Capitalization, Inward Expatriates and Royalty Payments to Non-Residents

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#### INTRODUCTION

The Spanish parliament recently approved the Fiscal, Administrative and Social Measures Act for the State Budget for 2004,<sup>1</sup> which contains, among other things, amendments affecting several Spanish provisions on international tax law. The changes introduced by the new Act have been in force since 1 January 2004 or will enter into force on 1 January 2005. They affect the Personal Income Tax Act (*Ley Impuesto sobre la Renta de las Personas Físicas, LIRPF*),<sup>2</sup> the Corporate Income Tax Act (*Ley del Impuesto sobre Sociedades, LIS*)<sup>3</sup> and the Non-Residents' Income Tax Act (*Ley del Impuesto sobre la Renta de no Residentes, LIRNR*).<sup>4</sup> The most important changes in the field of international tax planning concern the Spanish thin capitalization rule, the taxation of inward expatriates and the tax treatment of royalties paid to non-residents. The following note provides a short overview of the changes in these areas.

#### EXPATRIATES TAKING UP RESIDENCE IN SPAIN

Art. 9 of the LIRPF, containing provisions on the determination of tax residence in Spain, has been extended by an additional fifth paragraph that enables non-resident expatriates taking up residence in Spain to choose between taxation as a non-resident or as a "normal" Spanish resident. This benefit is limited to the first six tax years – including the year in which the change of residence takes place – and is aimed at strengthening the internationalization of the Spanish economy by attracting foreign executives to Spain.

This new provision is especially interesting for the purpose of international tax planning, taking into consideration that non-residents are taxed at a flat rate of 25% and their tax liability is limited to Spanish-source income, whereas ordinary Spanish residents are taxed on their worldwide income at a progressive tax rate up to 45%.

To be entitled to choose between the two different types of tax systems, certain requirements have to be met: the expatriate should not have been considered resident in Spain for a period of ten years prior to the change of residence to Spain; the assignment must arise out of a con-

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1. Proyecto de Ley de medidas fiscales, administrativas y del orden social ("Ley de Acompañamiento"), enacted on 23 December 2003.  
2. Law 40/1998 of 9 December 1998.  
3. Law 43/1995 of 27 December 1995.  
4. Law 41/1998 of 9 December 1998.

tractual agreement; work has to be effectively carried out in Spain and for a Spanish entity or a Spanish permanent establishment (PE) of a non-resident entity; and finally the income derived under the above-mentioned conditions must not be considered tax exempt under the LIRNR.

Expatriates who meet the above requirements will have to calculate which of the two possible forms of taxation has the most advantageous results. There are several aspects to be taken into consideration:

- amount of income: as mentioned, Spanish residents are taxed at a progressive tax rate of 15% to 45%, while non-residents are taxed at a flat tax rate of 25%. The right choice will therefore depend on the effective tax rate applicable to the relevant amount of income. In cases of high income, it will certainly be more advantageous to choose taxation as a non-resident;
- personal allowances: the LIRNR neither contains tax benefits (such as personal allowances, tax credits, etc.) nor enables the deduction of job-related expenses such as social security contributions, while the LIRPF does. It will therefore also depend on the personal situation of the inward expatriate, when choosing either taxation under the LIRPF or under the LIRNR. Under certain circumstances it may be more advantageous to be taxed as normal resident. The possibility of taking advantage of personal and family allowances, deductions of contributions to private pension schemes or credits for the acquisition of a primary residence, as well as to be able to deduct social security contributions, may reduce effective taxation to below 25% and therefore make taxation under the LIRPF more attractive;
- income other than personal income: non-residents are taxed for each type of income separately and there is no possibility of compensating positive and negative income, whereas the LIRPF allows compensation. Therefore, it may be more advantageous to be taxed under the LIRPF when losses are incurred, which may reduce effective taxation considerably; and
- foreign-source income: non-residents are only taxed in Spain on their Spanish-source income, while residents are taxed on their worldwide income. It may thus be more advantageous to be taxed as a non-resident when foreign-source income is derived. This aspect will also be influenced by other factors such as: level of taxation in the country in which the foreign-source income is derived, possibility of the application of a tax treaty, etc.

The new provision also affects taxation under the Spanish net wealth tax: inward expatriates who choose to be taxed as non-residents are liable to Spanish net wealth tax only on their assets located in Spain, while those who prefer to be taxed under the LIRPF are liable to Spanish net wealth tax on their worldwide assets.<sup>5</sup>

Time will tell whether or not the new provision will achieve the expected results relating to the internationalization of the Spanish economy. The Government certainly still has to resolve several issues on the correct implementation of the new provision, especially regarding the formal requirements to be met by expatriates wishing

to exercise their right to choose between two totally different forms of taxation.<sup>6</sup>

## THIN CAPITALIZATION

As a consequence of the decision of the European Court of Justice (ECJ) on 12 December 2002 (*Lankhorst-Hohorst*),<sup>7</sup> Spanish legislators have introduced a new paragraph to Art. 20 of the LIS on thin capitalization that excludes EU companies from the application of the thin capitalization rules. The Spanish thin capitalization rules provide that: if the average total loan made to a company resident in Spain by a non-resident related company during the tax year is more than three times the amount of the borrower's average net worth in that year, the amount of interest attributable to the excess will be recharacterized as a dividend for tax purposes. As a result, this interest cannot be treated as a deductible expense and is subject to dividend withholding tax.

The new paragraph introduced by the Fiscal, Administrative and Social Measures Act now provides that the thin capitalization rules will not apply to loans received from related companies resident in the European Union, as of tax years starting 1 January 2004.

## CFC REGULATION ("INTERNATIONAL FISCAL TRANSPARENCY")

According to the "international fiscal transparency" regime,<sup>8</sup> Spanish resident private persons and entities are subject to income tax on certain passive income of certain non-resident entities in which they own (directly or together with related parties) at least 50% of the capital, equity, profits or voting rights, provided certain conditions are met:

- the non-resident entities must be resident in a low-tax country (i.e. the income tax paid by the non-resident entity is less than 75% of the income tax that would have been payable under Spanish income tax rules); and
- the passive income to which the regime applies must be income from immovable property or rights not used in business activities, from financial assets, from loans between related parties and capital gains from the disposal of such assets.

The Fiscal, Administrative and Social Measures Act introduces to the Spanish CFC rules contained in the LIRPF as well as in the LIS a new provision to the effect that the

5. This liability to Spanish net wealth tax may soon be irrelevant, as a comprehensive reform of the net wealth tax is planned by the Spanish government, which will probably provide total net wealth tax relief for most current taxpayers.

6. Para. 5 of Art. 9 of the LIRPF itself provides that the Ministry of Finance will be in charge of establishing the proceedings necessary for the implementation of the new provision.

7. ECJ, 12 December 2002, Case C-324/00, *Lankhorst-Hohorst*, held that the German thin capitalization regulation infringed the right of establishment in Art. 43 EC.

8. In Spanish: *transparencia fiscal internacional*. This regime is contained in Art. 121 of the LIS and Art. 75 of the LIRPF.

regime will not apply to non-resident controlled foreign companies located in an EU Member State other than those included in the Spanish blacklist of tax havens.

## ROYALTY PAYMENTS TO NON-RESIDENTS

The above-mentioned Fiscal, Administrative and Social Measures Act contains a provision implementing Council Directive 2003/49/EC of 3 June 2003 on a uniform system of interest and royalty payments made between related companies resident within the European Union.

A new withholding tax rate on royalties paid to certain entities resident within the European Union has been introduced, amending Art. 24(1) of the LIRNR. The new withholding tax rate of 10% will be applied from 1 January 2005 and refers to royalty payments made by a Spanish company to a foreign company resident in an EU Member State or to a foreign PE located in an EU Member State of a company also resident in an EU Member State.<sup>9</sup>

In order to apply the reduced withholding tax rate the following requirements have to be met:

- both companies must be subject to and not exempt from Corporate Income Tax as defined in Art. 3(a)(iii) of Directive 2003/49/EC;
- both companies must be one of the types of companies mentioned in the Annex of the Directive;
- both companies have to be resident in the European Union and may not be considered resident in a third country under a tax treaty concluded with the third country;

- both companies must be related companies. Two companies are considered related for tax purposes if one of them has a share of at least 25% in the other or a third company has a share of at least 25% in each of the two companies. The share must have been held for at least one year prior to the date when royalty payments are made. The holding period may also be completed after having made the relevant royalty payments;
- royalty payments made by a PE must be considered tax deductible; and
- royalties must be obtained by a company on its own account and not as intermediary or authorized agent on account of a third party. Regarding PEs, royalties received must be linked to its effective business activities and must be considered taxable income in the country in which it is located.

Like Art. 13(1)(g) of the LIRNR, which implements the Parent-Subsidiary Directive, this new provision contains a limitation aimed at eliminating possible tax avoidance: the benefits contained in Art. 24(1)(i) of the LIRNR may not be applied if the entity receiving the royalty payments is owned for more than 50% by private persons or entities not resident within the European Union. This limitation does not apply if the company owned is able to prove that its incorporation is based on legal economic reasons.

9. See Art. 24(1)(i) of the LIRNR.

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