



SPENCE CLARKE TAX GUIDES

THE EFFECTS OF BREXIT ON THE TAXATION OF HOLIDAY HOMES, INVESTMENTS IN SPAIN AND OTHER PROBLEMS THAT WILL RESULT FROM BREXIT

Why Brexit will cause tax problems in Spain for UK residents

Effective from 30 March 2019, probably.....

One of the unexpected consequences of Brexit will be that UK residents who have bought holiday homes, or invested in Spain in some other manner, will suffer at the hands of the Spanish tax system because of their loss of status as residents of the European Union (EU) or European Economic Area (EEA).

UK residents will have problems because Spanish non-resident tax law mentions explicitly the EU/EEA status of taxpayers.

EU/EEA resident individuals and companies are granted beneficial tax treatment compared with residents of the rest of the world.

The Draft Withdrawal Agreement, Transitional Arrangements (19 March 2018) contains no clause that explicitly protects UK residents from the loss of their status as EU/EEA residents for Spanish tax purposes. It could be argued that UK residents are entitled not to be discriminated against by member states tax regulations, but the Spanish tax office is not known for being overly generous in such matters. We therefore have to plan for the worst and assume that the tax changes described in this article will apply with effect from 30 March 2019.

The UK/Spanish Double Tax Treaty of 2014 protects UK residents from some of the worst effects, but some potentially very serious disadvantages remain, as shown in the table:

	EU/EEA status	non - EU/EEA status
Rental income received by UK resident individuals or companies	Tax payable at 19%	Tax payable at 24%
	Deductions are allowed for most property costs	No deductions allowed. Tax applies to gross rental income
Exit tax is charged when an individual leaves Spain on unrealised capital gains.	In the case that the individual moves elsewhere in the EU/EEA, tax is deferred until asset sold or 10 years	No deferral. Tax has to be paid with the filing of the last annual Spanish tax declaration.
Dividends paid to a UK company that owns less than 10% of the share capital of a Spanish company	No tax payable in Spain	10% tax will be withheld in Spain
Capital gains tax on the sale of principal private residence when departing Spain	In the case that the individual moves elsewhere in the EU/EEA, the capital gain is exempt if the net sales proceeds are reinvested in a new home	No exemption to capital gains tax is available.
Inheritances	Taxpayer may choose between the State or Autonomous Regional systems	The State system will be mandatory

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Tax rate on rental income increases from 19% to 24%

And much worse—no tax deductions for property costs

And just when you thought it couldn't get any worse.....

Exit tax is payable in year of departure, with no rights of deferral

RENTAL INCOME

EU/EEA residents are entitled to deduct reasonable and properly documented property costs from rental income.

These include maintenance, utilities, local taxes, community charges, loan interest, depreciation, rental agents and related legal costs. Tax is payable on the net income at the fixed tax rate of 19%.

However, non-EU/EEA residents pay 24% tax and cannot deduct any property costs.

Example:

Jane bought an apartment in Spain with a mortgage and is renting the property until retirement when she plans to move to Spain. She receives 1,000 Euro a month in rent, has property running and mortgage costs that total 8,000 Euro a year and she is entitled to deduct depreciation of a further 3,000 Euro.

Pre Brexit her annual net income of 1,000 Euro results in annual tax of 190 Euro.

Post Brexit she will pay tax of 2,880 Euro, i.e. tax at 24% on her gross rental income of 12,000 Euro.

She will be 2,690 Euro worse off post Brexit.

To make matters worse, she will not be able to claim a tax credit in the UK for the extra Spanish tax. This is because she will have almost no tax to pay in the UK as the UK system allows reasonable deductions for property costs. As she will have little or no UK tax liability on the rent, Spanish tax cannot be set off.

EXIT TAX

In 2015 Spain introduced an exit tax.

Individuals who leave Spain with investment assets exceeding 4m Euro are liable to pay capital gains tax on the unrealised profit of their investments valued on the last day of the last year of assessment. This limit is reduced to 1m Euro when the individual holds more than 25% of a company.

There is no right of set off of any latent capital losses.

If the individual moves to another EU/EEA country then the individual has the right to defer payment of tax until the disposal of any particular investment or 10 years, whichever comes first.

The maximum capital gains tax rate in Spain is 23% and is the same in all the Autonomous Regions.

Consequently, individuals leaving Spain to move to the UK will lose this right of deferral and will have to pay 100% of the tax in the year of departure.

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Dividends paid by some Spanish companies to a UK parent companies will pay tax in Spain

Individuals moving to the UK will have to pay capital gains tax on selling their Spanish home

18 different inheritance tax systems in Spain

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DIVIDEND TAX

Spain's adoption of the EU parent/subsidiary rules provides complete exemption of Spanish withholding tax on dividends when the parent company holds at least 5% of the Spanish subsidiary's share capital or the cost of the shares exceeds 20 million Euro.

This will change with Brexit and only article 10 of the UK/Spanish treaty will apply.

Article 10 requires that the parent company holds at least 10% of the Spanish subsidiary's share capital. Otherwise, withholding tax of 10% will be applied to the dividend from Spain.

CAPITAL GAINS ON SALE OF HOME

In Spain the sale of the principal private residence is not necessarily exempt of capital gains tax.

Only those over 65 years old benefit from a general exemption on tax payable on any capital gain. This applies as long as the individual has lived in the home for at least three years prior to the sale.

Other owners may only claim exemption in the case that they invest the net proceeds of sale in a new home. Partial reinvestment results in pro rata exemption.

A problem arises when an individual sells a home in Spain to move to another country. Spanish rules allow the exemption only if the individual moves to another EU/EEA country.

Consequently, post Brexit, persons moving to the UK will not be entitled to exemption to income tax on the capital gain on the sale of their homes.

INHERITANCE TAX

The Spanish inheritance/gift tax (IGT) system taxes each beneficiary, not the Estate.

Non Spanish resident individuals are taxed on the acquisition by gift or inheritance of real estate or other assets located in Spain or subject to the jurisdiction of Spanish law, e.g. shares of Spanish companies, bank accounts.

The seventeen Autonomous Regions of Spain collect and regulate IGT but the State has its own system that only applies to non-resident beneficiaries. In effect Spain now has 18 distinct IGT systems.

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Some regions of Spain have generous tax exemptions that UK residents will lose

The original State IGT system has hardly changed since it was enacted in 1987 but the Autonomous Regions, which started out with the State system, have made many changes over recent years.

As a result, the IGT systems in Spain now diverge considerably, to the extent that some Regions have almost completely exempted IGT for close family inheritances.

It is generally accepted in Spain that the widely diverging systems applicable to non-residents and residents result in the unfair treatment of non-residents. This was challenged in the tax tribunals and led to the ECJ requiring Spain to adjust its tax treatment but only for EU/EEA citizens.

Spain did this by simply granting EU/EEA residents the right to choose, as they preferred, the State IGT system or Autonomous Region IGT system where property is located.

UK residents will lose this right when they cease to have EU/EEA resident status.

Example:

Peter is a widower who dies after Brexit, leaving his holiday home in Andalucia, valued at 750,000 Euro, to his only son John. The property was jointly owned by Peter and his wife and Peter inherited his wife's share on her death a few years ago. Peter and his wife were originally residents of Andalucia but when his wife died he decided to return to the UK to live with his family. He didn't sell the property which has since been used by the family as a holiday home. The Spanish property was Peter's only substantial asset.

John is subject to the State IGT tax system and is only entitled to deduct the tax-free allowance of 16,000 Euro. His IGT liability is 195,200 Euro. No UK IHT is payable on the estate because of the combined nil rate band of John's parents and so John is not able to benefit from UK unilateral tax relief.

Had Peter died pre-Brexit, John would have paid ZERO tax because John would have had the right to apply Andalucia IGT which exempts inheritances valued up to 1 million Euro.

Admittedly, this example is based on unusual circumstances, but it serves to emphasise how seriously Brexit will affect UK families with holiday homes in Spain. All the Autonomous regions in Spain provide more generous IGT allowances than the State system which UK residents will be forced into.

In fact, for close family, Andalucia has a very generous nil rate band of 1 million Euro per beneficiary but Madrid goes even further and exempts 99% of the value of inheritances. Its hard to imagine Spain as being a low tax jurisdiction but in some circumstances, it certainly is.

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The UK Government need to act to protect its residents

In summary...

The UK/Spanish tax treaty undoubtedly provides some protection to UK residents, but it does not cover all the problems that will arise from Brexit, as we have explained.

Inheritance tax, for example, falls completely outside the provisions of the tax treaty and the injustices that will be caused by Brexit to some families are truly appalling.

Recent experience shows that it is not common practice for the Spanish Government, whichever its political persuasions, to make changes to tax law, even when it is obviously unfair, unless forced to do so by the ECJ or its own Constitutional Court.

Much as the UK is a very important source of buyers in the Spanish property market, this alone will not be enough to bring about a change in tax law for the benefit of UK residents.

Arguably some of the areas of tax law analysed in this article contravene article 31 of the Spanish Constitution that requires the tax system to be “Just and inspired by the principles of equality and progressivity and never confiscatory”. The courts do eventually overturn bad law in Spain but the process is expensive and excruciatingly slow, and tax has to be paid pending an appeal. Most will not appeal against unfair taxes.

Spain has no real incentive to be fair to UK residents

In the meantime, it will be all too easy for the Spanish establishment to simply brush aside criticism and claim that UK residents should suffer the consequences of their decision to leave the EU and that there is no justification for UK citizens to be treated differently to, say, residents of the USA.

Unless arrangements are made between the UK and Spain to deal with these issues in a sensible manner, UK residents with investments in Spain may find that the tax environment has changed significantly for the worse.

The UK appears not to be aware of the problems

The author has contacted both the UK Embassy in Madrid and HMRC to ascertain whether the UK Government is aware of these problems and is taking account of these in its Brexit discussions with the Spanish Government. It was reasonably clear that no such awareness existed before this contact and, when questioned over the intention to act, the response from the officials was non-committal, claiming that it is not HMRC’s policy to comment on such matters.

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