Inheritance Tax in Spain and ways to avoid it!

There is a potential sleeping time bomb, both here in Spain but also back home in the UK, for many home owners with significant capital or equity in their homes. But it is a bigger threat than that because Inheritance Tax (IHT), or ISD to use the abbreviation of the Spanish equivalent, is calculated on the estate value i.e. all assets and is not limited just to the home in which you live. The tax in the UK is based upon worldly asset value and the same applies here in Spain if you are a resident. But, even if you are a non-resident in Spain, any assets onshore can be exposed to the tax dependant, of course, on the value.

Many British property purchasers understandably assume that the IHT regime in Spain is likely to be similar to that in the UK. This is a dangerous assumption for the two tax systems are vastly different and the Spanish ISD is potentially far more punitive despite the top tax rate being lower than that of the UK at 34% versus 40%. Punitive because it applies at much, much lower levels.

It should be stated at this point that there is some 'greyness' in interpretation as to how the tax is actually calculated. There are potentially three numbers that can apply to property; the 'escritura' (what is declared on the deed), the 'catastral' (local council rateable value) and the market value. Most observers interpret Hacienda tax rulings as being based upon the middle or 'catastral' value. However, for absolute peace of mind, we always suggest that the 'worst case scenario' be adopted and that translates to calculating risk on the higher number i.e. market value. The reality is likely to result in a lower tax calculation rather than the opposite. There will be no hidden and nasty surprises in adopting this stance.

IHT is often referred to as a 'voluntary tax' because it is relatively easy to overcome. There are various ways in which the tax can be reduced or avoided (or 'mitigated' to give the correct terminology) but more on that in part 2.

Part 1 – A guide to Spanish ISD (or Inheritance Tax).

The primary differences between the IHT regimes between the UK and Spain are threefold;

1) the lack of a spouse exemption
2) the allowances lie with the beneficiaries and not with the deceased
3) the allowances are much smaller in Spain than in the UK.

1). Spouse exemption.

In the UK the family home is automatically passed to the surviving spouse free of tax. That is not so here in Spain; the asset is deemed jointly owned and therefore subjected to tax and the allowances of the individuals.

This has the potential of coming as a shock to those property owners who do not plan ahead. On the first death, unless the recipient (the surviving spouse) is a resident in Spain, has been in the family home for at least 3 years, and has net wealth of less than €400,000, the unusually (for Spain) Andalucian allowance of €125,000 is not applicable and the standard National allowance of €16,000 applies. This sum is deducted from the amount receivable (the deceased's half of the home, any other joint assets and anything in their own name. Hence, even taking a fairly low number as an example, it can be seen that some IHT may be payable.

And the problem often gets worse come the death of the second or surviving spouse! As the recipient of the first partner's assets, all the 'eggs will be in one basket' and, unless the beneficiaries are residents qualifying in their own right for deferment of tax and living in the parent's house, their own allowances will again be reduced to the standard €16,000. Most beneficiaries, of course, are not resident in Spain and live back in the UK so they would not be eligible for anything other than the default standard of €16,000.

Most British property owners, because of the IHT regime that generations have lived with, have a simple attitude that firstly the surviving spouse takes all, and only then will the end beneficiaries of children and grandchildren be considered.

The Spanish attitude is different because the ISD is also different. They will pass assets including the family home on much earlier and will also share it out to a far greater degree, thus using up many times the individual beneficiary allowance.

So the British have to either learn from the Spanish and/or take other more positive steps to keep valuable assets out of the hands of the Spanish tax authorities.

2). IHT Allowances.

In the UK, in addition to the spouse exemption on the family home, each deceased person has an allowance of £285,000 (adjusted periodically via the Budget) before any tax applies. In Spain, dependant on the class of beneficiary and their residency/non-residency status as well as the province in which the resident lives, the allowances lie with the beneficiary and are potentially tiny in comparison.

The Spanish national default allowance for non-residents is a mere €16,000. So, for a couple retiring to Spain without having taken tax residency, this allowance is deducted from the inheritance to determine the level of net receivables upon which tax applies. Even on a relatively low value, tax could still have to be paid.

For example, Mr & Mrs Client are non residents. Their home is jointly owned with a value of €200,000 and there is no mortgage. On death they have willed their shares to each other. Mr Client dies leaving his one-half share to his wife. Mrs Client's allowance is only €16,000 as a non resident so tax is payable on €84,000 according to a Tax Table. This amount falls in the middle of the table and a top rate of 18.7% on the €84,000 is due. That calculates to almost €10,000. A hefty slice!

To make matters worse, Mrs Client has to pay the tax of approximately €10,000 before she can officially take ownership of here deceased partner's share. In other words, she cannot borrow against the home to do as the Hacienda has a lien or charge on the property until the tax is paid…or sell it!

And on her death, matters getter worse for the end beneficiaries! Let's say that there are two children, both living in the UK, who are the benefactors of the estate. Now the property, still valued at €200,000 is passed to them after Mrs Client's death. Their individual allowances are still only €16,000 so they both end up with a liability of €10,000, or €20,000 in total! Without proper planning a total of €30,000 tax is payable on one property and on two deaths. An awful lot of tax for a fairly low valued home! Imagine what the tax will be on more valuable assets being passed on with no tax planning!

3) The allowances are tiny!

Andalucia province has taken an unusual step in breaking away from the national standard and offers an exemption of €125,000 rather than the normal €16,000. However, it may sound good but the reality is that the exemption has certain caveats that must be met in order to benefit. These are as follows;

i) The recipient must be resident for tax purposes, with residency registered at the local town hall for at least 2 years.
ii) The recipient's worldwide worth cannot be higher than €400,000
iii) The tax allowance will only apply if the beneficiary lives in the same property for 10 years

Assessing the tax level.

Stage 1 – The classification of the beneficiary falls into 4 categories;

Group 1	Direct relatives.	Married couples and children both natural and legally adopted under 21 Allowance €15,956 plus €3,991 for every year under 21 to a maximum €47,858
Group 2	Children over 21	Allowance of €15,956
Group 3	Other relatives	Uncles, aunts, nephews, nieces, cousins and step parents Allowance of €7,993. This also includes unmarried couples.
Group 4	Other distant relatives and unrelated persons.	

Stage 2 – Surcharges

When the tax charge has been established by reference to the above groups, a surcharge is then applied based upon the pre-existing wealth of the beneficiary and their relationship to the deceased.

Pre existing wealth up to €402,678	Group 1 & 2 no surcharge Group 3 increase by 59% Group 3 increase by 100%
Pre existing wealth from €402,679 up to €2,007,380	Group 1 & 2 increase by 5% Group 3 increase by 67% Group 4 increase by 110%
Pre existing wealth from €2,007, 381 up to €4,020,770	Group 1 & 2 increase by 10% Group 3 increase by 75% Group 4 increase by 120%
Pre existing wealth over €4,020,771	Group 1 & 2 increase by 20% Group 3 increase by 90% Group 4 increase by 140%

Stage 3 – Tax payable

As can be seen, the surcharge increases the more distant the relation is. Unrelated wealthy beneficiaries have been known to pay a tax rate in excess of 80% of the inheritance!

Tax Table

Tax base Up to Euros	Tax Payable	Remaining Tax Base	Applicable Tax Rate %
0	0	7,993	7.65%
7,999	611	7,987	8.50%
15,980	1,290	7,987	9.35%
23,968	2,037	7,987	10.20%
31,955	2,851	7,987	11.05%
39,943	3,734	7,987	11.90%
47,930	4,685	7,987	12.75%
55,918	5,703	7,987	13.60%
63,905	6,789	7,987	14.45%
71,893	7,943	7,987	15.30%
79,880	9,166	39,877	16.15%
119,757	15,606	39,977	18.70%
159,634	23,063	79,754	21.25%
239,389	40,011	159,388	25.50%
398,777	80,655	398,777	29.75%
797,555	199,291	and over	34.00%

Part 2 – Ways to mitigate Spanish ISD (Inheritance Tax)

Because of this very real issue, every homeowner needs to be aware as to how they and their beneficiaries might be affected by a death and to plan accordingly from a position of strength of knowledge. It is not something to go into a panic over; rather research the subject and take whatever steps are necessary.

There are certain ways that this issue (let's not call it a problem!) can be overcome. A Will really should be an automatic document to produce, after consultation with a solicitor, as this gives clear guidance as to where assets are to be transferred to on death. But that does not solve the threat of ISD, especially if beneficiaries are not going to be resident here in Spain.

So what choices do you have to avoid the tax?

1) Consider adding the end beneficiaries to the deeds (known as the Escritura) of the property early.

There are some downsides to this;

i) You may not like to effectively give away part of your home with you still needing to live in it! This can, to a degree at least, be overcome by taking a 'General Power of Attorney' from each person you are gifting to, although these documents can be cancelled without notice.
ii) A Capital Gains Tax may be payable on the part being gifted.

2) Maximize your mortgage.

Tax is only payable on the net asset after the deduction of legitimate charges or mortgages. When buying a property consider a long term 'Interest Only' mortgage which will keep the debt at a high level thus reducing the equity in the property. Do not worry about having a mortgage; keeping your capital elsewhere and out of Spain gives you the ability to meet interest payments. And even investing such capital conservatively is likely to produce an added income over and above the Euro interest payable on the mortgage. A double benefit of extra income and IHT saved!

3) Take out Life Assurance.

A simply Level Term or preferable a Whole of Life policy written into trust will provide sufficient funds to meet the tax as and when due. You are not avoiding the tax by electing for this route, but simply ensuring that monies are available to meet the bill. We are able to give independent impartial advice in this respect.

4) Consider an Equity Release scheme.

These are the newest of products to battle IHT and involve the creation of a mortgage on the property backed by an investment offshore to produce an income. The latter point is important for the scheme to work in the eyes of the tax authorities.

Let's take an example.

Clients Mr & Mrs A have a home valued at Euros 300,000 on which there is no mortgage. They are non resident here and have no other assets in Spain. As mentioned above, on 1st death, the estate is deemed jointly owned so the calculation will be based upon 50% i.e. 150,000 being subjected to the allowances of the beneficiaries. If the surviving spouse &/or children are also non-resident, then there will be a tax bill to pay. On the 2nd death it could be worse for, if the surviving spouse has inherited the 1st's half of the home, now we are talking the full value of the home being exposed rather than just 50%.

So a mortgage will be raised, say at 80% of the value or 240,000 which is then taken offshore into Trust. For residents the products used are different than for non-residents due to the differences in the tax rulings. So we now have 240,000 as a mortgage and a like sum as an investment. The latter will be used to pay interest only on the mortgage as well as to generate a small income, normally just a couple of per cent, by way of added income. Something for nothing almost!

But now on 1st death, 50% of the equity only amounts to 30,000 rather than 150,000 and, dependant upon who the beneficiary or beneficiaries are, there will probably be little or no tax to pay. Ditto on 2nd death. An efficient way of mitigating the tax and keeping the assets for your beneficiaries rather than the tax man!

In summary then you can see that knowing there is an issue (and not a problem) to address is more than half the battle. Knowledge is power and, in the case of Inheritance Tax, it can save a small fortune!

In this respect, we are able to assist and personalize our advice and actions on your behalf.

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