The Offshore Tax Planning Review

VALUATION OF UNQUOTED SHARES FOR TAX PURPOSES IN SPAIN

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Introduction

My last article[2] considered the valuation for tax purposes of real property in Spain. Apart from property (and of course the associated chattels and motor cars), the second most likely Spanish asset to be owned by a foreigner is a business. That commonly takes the form of a limited liability company which can be either a Sociedad Anónima (SA)[3], or more often a Sociedad Limitada (SL)[4].

Spanish companies are also used occasionally by foreigners for purposes other than business, the commonest being property holding, with various motives and objectives. Recently there has been a small rash of companies (almost without exception SL) inserted into Spanish property-ownership ownership structures, normally with a view to "blinding" the enquiries into ultimate ownership facilitated by the 5% Special Tax[5].

Whether directly or indirectly, owned the shares of such companies from time to time need valuing for tax purposes. Those companies to which I

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2 OTPR, Volume 3, Issue 3.

3 Equivalent to a UK Public Limited Company (PLC), and with a minimum capitalisation of Pesetas 10 Million (approximately £50,000).

4 A private limited company, with a minimum capital of pts 500,000 (approximately £2,500).

5 Covered in some detail in OTPR Volume 2.

refer are not quoted on a stock exchange. The valuation of unquoted shares - certainly for commercial purposes - is as much art as science and (if I may quote from my previous article) has, like beauty, much to do with the eye of the beholder. Amongst the beholders will be Hacienda[6], who will need to be satisfied that any taxable transactions in these assets are reported where required at a tax valuation which satisfies the law.

Aim

This article purports to offer some information about the valuation for Spanish tax purposes of shares of unquoted companies. In some senses, that information is surprisingly thin. Spain's approach to tax valuations is not art and, in my opinion, hardly science either. I suspect, therefore, that the true aim of this article is nothing more or less than to demonstrate that, once again, Spain is different, and that any approach to tax valuation of unquoted shares must be based in a judicious mixture of law and practice to produce a dependable result.

The Taxes

Transactions in or holdings of unquoted shares may be subject to a number of taxes, depending on the circumstances. Those most likely principally to concern a professional in his consideration of a holding and/or putative transfer are:

* Stamp duty equivalent. (*Impuesto sobre Transmisiones Patrimoniales y Actos Juridicos Documentados*) (ITP.)

* Corporation Tax. (*Impuesto sobre Sociedades*) (ISS.)

* Personal Income Tax (*Impuesto sobre la Renta de las Personas Fisicas*) (IRPF)

* Tax on realized gain. This is assessable to ISS or IRPF as appropriate

6 Spain's equivalent of the UK's Inland Revenue.

* Inheritances and Gifts Tax. (*Impuesto sobre Sucesiones y Donaciones*) (ISD)

* Wealth Tax. (*Impuesto sobre el Patrimonio*) (IP)

Tax Valuations in General

Background

Spain lacks a coherent system of valuation for tax purposes. Indeed, one commentator suggests that " ... valuation in the Spanish tax system is more a product of history than a result of reasoned design"[7]. That this is true may be seen from the absence in the law of guiding principles for valuation. Each tax adopts its own valuation criteria, and whilst these often cross-refer to those in other taxes there is no overall conceptual scheme. In Spain's self-assessment system, the General Tax Law (*Ley General Tributaria*) might be expected to contain such principles or concepts but does not, containing only an approximation thereof, and that only in the partial and procedural area of the methodology to be adopted by the tax authority in the verification of values[8] reported by taxpayers. Jurisprudence whilst, of course, interpreting statute plays no role in providing definitions of the largely unsatisfactory words and terms employed in the law, and so is of no real help.

In 1977, the legislators did have a somewhat torpid stab at attempting to make just one law (the then equivalent of the Wealth Tax law) the point of reference for all tax valuations, and hence in effect a sort of general law of valuations in that aspect of its provisions. But as Professor César Albiñana

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[7] Miguel Carrobé Géne speaking in 1991. He went on to add, inter alia, that uncertainty and inequality of application were characteristics of the system, and that the great "terminological dispersion" and scarce strength of logic demonstrated the absence of clear and organized common principles of valuation; that there is no adequately defined system nor concept of valuation, but rather an agglomeration of reiterative terms, mostly imprecise, and without juridical definition.

[8] Professor César Albiñana Quintana, arguably the leading fiscal commentator in Spain, characterises this verification of reported values as "..without doubt, the major source of conflict in relations between taxpayers and the fiscal authority".

says (in my paraphrasing) "the valuation criteria introduced by that law were so irrelevant (sic) as to be incapable of performing the express function for which they were designed".

General Procedure

In arriving at a valuation for tax purposes it is first necessary to consider for what purpose one seeks a valuation and then to proceed directly to the law[9] for the tax in question. Each of the taxes listed earlier rehearses its own valuation criteria to be applied, and it is the case that different taxes can produce different valuations of the same event or transaction or object. Having established a value for the purpose of the tax in question, the taxpayer then reports that value and awaits the response of the tax authority. That can be either to accept the taxpayer's valuation or to challenge it with a valuation of its own.

The right to verify reported values is given to the tax authority in Article 52 LGT[10], and provides a list of permissible mechanisms by which the verifying valuation may be arrived at, the sixth and final one of which is "whatever other methods may be specified in the Law for each tax". It is the case therefore that the process of verification, where applied, is not only examining the acceptability and accuracy (where the latter is ascertainable) of the basic propositions on which the taxpayer's reported value is allegedly based, but also whether he has then correctly applied the relevant procedures and calculations to those propositions.

From that point onwards matters may, and often do, proceed to an ugly squabble as the taxpayer then exercises his right in turn to challenge the tax authority's revaluation ... and thence on to the tie-breaker provisions.

Where the taxpayer escapes the verification process, his assessment will be based upon his reported valuation provided it has demonstrably been calculated in accordance with the rules or bases contained in the tax law governing the reported event or transaction.

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9 ....and to the subsidiary Regulations (*Reglamentos*) for that law.

10 *Ley General Tributaria* - The General Tax Law, and the nearest equivalent to the UK's Taxes Management Act.

The So-Called "Real" Value

In many areas, the tax system tends to reach towards what it calls a "real value" (*el valor real*). Quite the most significant feature of this "real" value is that it is entirely hypothetical. Neither the legislation nor jurisprudence define what is or may be a *valor real*, nor how it may be calculated. It should certainly not be confused (though it may on fortuitous occasion coincide) with a market value, by which I mean a price actually obtained in a genuine arm's-length transaction. A *valor real* may, perhaps, best be described as an attempt to determine some form of theoretically objective open-market value, free from subjective influences and supposing the usual arm's-length transaction between willing and unencumbered parties to a putative sale in theoretically stable, free, and neither optimistic nor pessimistic market conditions. Just how close to this impossible model actual practice gets depends upon a variety of empirical and other factors. Once again we can turn for help only to the verification procedures referred to above (Art 52 LGT) which rely heavily on the use of "expert opinion" in arriving at such a value. Many[11] of the so-called expert opinions provided to the taxpayer by the tax authority as the basis for a revised (always increased) assessment are either mathematically derived from a frankly asinine series of formulaic tables or grossly subjective. This struggle to determine a *valor real* is one of the least satisfactory aspects of the whole Spanish tax system. The perceived necessity for such a valuation basis may, in large part, be due to the long history in Spain of outright fraudulent underdeclaration by taxpayers and - it has to be said - their advisors.

... and ever onward

Lest the reader at this point give up, clutch his brow or other suitable portion of his anatomy, and declare that since the whole matter is obviously so anarchic it is pointless to pursue it, let me reassure him. Far from being anarchic, the business of attributing a value for tax purposes is so defined in each tax law that strict adherence to the bases and procedures is a *sine qua non*. It is in the application of those that the difficulties and uncertainties arise. The procedures established by law suffer from generations of tinkering and an entirely uncoordinated approach. The system itself lacks consistency and, on occasion, apparent reason. Practice,

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[11] Especially those related to real property.

rather than jurisprudence, is what makes it work, and that can be something of an occult art and very regional in its application.

Bases of Valuation of Unquoted Shares

The valuation of unquoted shares is not immune from this uncoordinated and unsatisfactory approach. As will hopefully become apparent, however, there may even be some benefit in this. It may be argued that there may be planning opportunities in that the regime applicable to such shares is capable of producing some interesting results when compared with, say, UK practice. Probably the most interesting differences are the exclusion of goodwill in some of the mathematically calculated valuation procedures, and the fact that there is no recognition in the rules of anything approaching a control-basis valuation of partial shareholdings.

There is in Spain no equivalent of the Share Valuation Office. So far as we are able to ascertain, the official colleges (professional bodies) of valuers have no such specific expertise (although individual practitioners may have developed an expertise and reputation in the field). Valuations therefore tend to be based either on an agreed sale/purchase price or on the underlying net assets and the balance sheet of the company.

The valuation bases for unquoted shares used in the various taxes include the following:

1. The price actually paid/received in transactions for valuable consideration.

2. The "real" value.

3. The "theoretical accounting value", from the last balance sheet where approved by auditors.

4. Where there is no audited balance sheet, the higher of:

   4.1 The nominal price (or the partly paid element of that).

   4.2 The "theoretical accounting value", from the last approved but unaudited balance sheet.

4.3 That which results from capitalizing at 12.5% the average over the last three accounting years of the net pre-tax profits (including distributions to shareholders and amounts set to reserve other than balance sheet adjustments).

5. "Net book value", defined as average acquisition price divided by the number of shares (i.e., straight-line).

6. In associated operations, market value.

Goodwill

Except in purchase/sale transactions, where it must be supposed that the vendor has included it within the price, goodwill is effectively not included in tax valuations of unquoted shares. Accounting rules prohibit the inclusion in the accounts of a company of any figure to represent its own goodwill. The goodwill of subsidiaries or associated companies may only be reflected if an amount was actually paid in respect of goodwill upon acquisition by purchase of the subsidiary or associated company.

It is, of course, theoretically open to whoever is making the calculation (be it the taxpayer or the tax authority upon verification) to include some element in respect of goodwill if a "real" value is required by the words of the tax in question. The two principal taxes where "real" value is technically required are ITP (stamp duty) and ISD (inheritance and gifts tax). Note, however, my comments further down.

Control Basis Versus Straight Line

Again, other than in purchase, sale transactions where, once again, it is open to both parties to agree a price (which will then, most likely, become the appropriate tax valuation basis), there is no concept of a control-basis valuation of partial shareholdings.

The approach consistently adopted throughout is that of valuing the whole company, and simply taking the straightline fraction of that for the partial shareholding.

Pooling

The possibility of acquiring at different times and at different prices the shares of an unquoted company is to the writer's knowledge dealt with in clear words in only one place, which is to say Art 74 of the ISS (corporation tax) Regulations. Those words make it clear that, upon alienation, the acquisition price for tax purposes of such shares shall be the average acquisition price of all of them.

Interestingly, this same Article specifies and requires a straightline basis of calculation for partial shareholdings, and again is the only point at which partial shareholdings are specifically addressed.

Rights Attaching to Shares

In those cases where rights attaching to shares (for example, preferential subscription rights) may be split away from the share and sold, the price of such rights if indeed actually sold may be deducted from the value of the share as determined by the processes mentioned above.

Conflict of Valuation Bases

In, for example, a transfer *mortis causa*, there should be no conflict, since ISD requires unequivocally a "real" value to be reported, and there is no other surrounding or connected taxable event which might cause a different valuation to be applied in accordance with the rules of another tax.

The principal skulker in the woodpile is ITP (stamp duty). ITP requires a "real" value. But ITP is applied when an event assessable to another tax occurs. The prime example is a sale, when the vendor must also report the transaction for consideration of income (IRPF) or corporation (ISS) tax on the gain/loss. These latter taxes focus on arm's-length transaction prices or theoretical values derived from the balance sheet or the capitalization formula mentioned earlier or the nominal price if higher. The question becomes then of how the "real" value is arrived at, and what is the position if it is greater (or even smaller) than the price or the formulaic value.

The answer for the moment is entirely pragmatic (and, note, not based in strict law). In practice there is no difference. There is no known method of determining a "real" value of an unquoted company shareholding different from that arrived at by employing the mechanisms used for the other taxes. In the writer's experience, and in that of other practitioners whom I have consulted, the tax authority has always in practice taken the higher of the nominal or the theoretical (balance sheet/net income) values, compared that with the price (if any) actually paid, and then taken the higher of those latter two.

That is not to say that at some future time, the tax authority[12] may not establish a mechanism by which they can perform a "real" valuation of share transactions. The obvious fundamental difference would be to include factors to represent goodwill and possibly control.

Non-Resident Companies

At no point is any distinction drawn between Spanish and foreign, or resident and non-resident, companies. The procedures discussed above therefore apply to any company. About the only caveat to that statement is that it is at least possible that a value attributed to a share for tax purposes in the overseas jurisdiction, and according to its valuation rules, might legitimately be taken as a benchmark for calculation (or, rather, attribution) of a *valor real*, where such a value is to be employed[13]. I hasten to add that this is to my knowledge a purely hypothetical observation, and I am unaware of any cases where this approach has been adopted at the instance of the tax authority.

The UK's control-basis approach to valuations of partial shareholdings might lead to a significantly different valuation from Spain's straightline approach (quite apart from the issue of goodwill). In considering inheritance taxes, therefore, and a Spanish resident inheritor of a controlling

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12 A potential further confusion is that the tax authority for both ISD and ITP is not Hacienda (Spain's equivalent of the UK's Inland Revenue), but the government of the regional Autonomous Community (such as Andalucía, Cataluña, Baleares, etc) for that part of Spain in which the taxable event occurs. The regional governments are independent of each other, and there is no necessary guarantee that they will act in concert or to any common standard in these matters.

13 ITP would not be in issue, since the shares would not be Spanish sited. ISD, however, may be a real risk.

shareholding in a UK company, there is every reason to adopt the Spanish practice where possible, and not simply import the UK's IHT valuation.

Practice

As is so often the case, the poor old professional has to take a view. The Scylla of the law and the Charybdis of practice and pragmatism leave his little raft somewhat exposed to the risk of being torn apart. Declare the technically correct valuation and the client will complain that it is too high and that his friend's tax advisor used a different basis with no problem; use the lower basis and have it increased on verification by the tax authority, and the client will complain at the additional fees and question his advisor's competence. In such circumstances, and in the specific case of unquoted company shareholdings, it is probably wiser to navigate by the seat of the pants.

Practical tax reporting generally takes the following course:

1. On a sale for valuable consideration, note the price per share.

2. If the company has an audited balance sheet, calculate the price per share from the value of the company thereby represented.

3. If the company does not have an audited balance sheet, take the higher of the three prices per share derived from the last approved balance sheet, a capitalization of the company's average income over the last three years at 12.5%, and the nominal price or partly paid portion thereof.

4. Pick the highest of the figures so far calculated or noted.

5. Check to see whether the rules of the tax for which you are reporting permit you choose a valuation basis lower than that you have just picked, and that you can defend your choice.

6. Report 5 if you can. If you can't, report 4.

The reader will note that the above procedure does not consider any question of market or "real" valuation, and that such issues as goodwill and control-basis valuation are simply ignored.

Conclusion

Sad, really. Tax lawyering brought practically to nought. Viva pragmatic compliance. Readers of this review will have spotted nevertheless that there are several features of potential advantage to the cross-border client, and not inconsiderable scope for planning in the right circumstances.