

## THE CANARY SPECIAL ZONE ("ZEC")

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### Background

The Canary Islands are mainly known to most Europeans as a tropical tourist resort alongside the West Coast of Africa, some four hours flight away from the heart of the EU in Brussels. In the future it may also become an attractive place for international investments and transactions due to the extremely beneficial fiscal treatment made available under the legislation governing the so-called Canary Special Zone ("Zona Especial Canaria"/"ZEC"), an off-shore zone created by Law 19/1994, which, after having overcome some initial obstacles, may soon appear in the business world.

Since its acquisition by the Crown of Castile in the 15th century, the archipelago has formed part of Spain although it has always maintained some legal peculiarities which, in the economic field, led to a specific economic and fiscal régime, aimed at compensating the disadvantages deriving from the insularity and remoteness of the community, with the following characteristics:

- Total free trade, in relation to both import and exports.
- No customs barriers.
- No state monopolies.
- Tax advantages: no customs duties, no excise taxes, no turnover taxes on sales of merchandise and a lower tax burden on business profits.

The incorporation of Spain into the EEC in 1985 raised the issue of the status of the Islands. Under Protocol 2 to the Treaty of Adhesion, they became a part of the Community but remained outside the customs union as well as the territorial ambit of application of the agricultural, fishing and commercial policies, although

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Article 25.4 of the Treaty enabled the Council to resolve upon the integration of the Canaries within the customs territory of the Community as well as on possible modifications of their status.<sup>2</sup>

In 1990, at the request of the Regional Parliament, the Spanish Government with the support of the Regional Government, started negotiations with the EC Commission which led to a substantial modification of the special economic régime of the Islands. At the level of Community law, the change materialised into two provisions, namely:

- Article 6 of Council Regulation 91/1911,<sup>3</sup> which established a timetable for the progressive introduction of the Common Customs Tariff (CCT) to the Canary Islands during the transitional period which would not extend beyond 31st December 2000, and
- Council Decision 91/314,<sup>4</sup> adopted with a view to establishing the so-called Poseican programme, aimed at providing the Canary Islands with Community support to help them become fully involved in the dynamic of the internal market. In particular, this programme sets up specific options which take into account the serious lack of development of the Islands, aggravated by several circumstances (insularity, remoteness, small size, difficult terrain and climate) whose unchanging nature and combined impact have serious effects on their economic and social development. For these reasons, and as part of the progressive introduction of the CCT, Poseican also contemplates the creation of a special tariff or the derogation of the common commercial policy for certain sensitive products.

Within Spain, the Spanish Parliament, on 7th June 1991, passed a Law modifying the tax aspects of the Economic and Fiscal Régime of the Canaries which, in many respects, put an end to its traditional basic features as it involved the creation of a local VAT, the so-called Canarian indirect general tax ("Impuesto General Indirecto Canario"/ "IGIC"), the establishment of a set of duties for imports into

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<sup>2</sup> Protocol 2 of the Treaty of Adhesion of Spain and Portugal to the European Communities, signed on 12th June 1985. This Treaty was implemented in Spain by Law 10/1985, of 8th August, concerning authorisation for Adhesion of Spain to the European Communities.

<sup>3</sup> Council Regulation 1911/91/EEC of 16th June 1991, on the application of the provisions of Community law to the Canary Islands, O. J. No. L 171 p 1.

<sup>4</sup> Council Decision 91/314/EEC of 26th June 1991, setting up a programme of options specific to the remote and insular nature of the Canary Islands (Poseican), O. J. No.L 171, p 5.

the Islands (to be progressively reduced until the year 2000, when they will be fully replaced by the EU customs tariff) and the elimination of special reliefs on the taxes levied on business profits.

This new régime soon proved to be insufficient to cover the fiscal aspirations of the Islands and, as a result of political compromises between the State and the Regional Government, was profoundly modified by Law 19/1994<sup>5</sup> which, apart from partly restoring the beneficial fiscal treatment traditionally afforded to business profits made in the Canaries, created the ZEC.

#### **Initial Non-compliance with EU Legislation**

Under Law 19/1994, those companies created in the Islands in accordance with the provisions governing the ZEC become practically exempt from any taxes, both direct and indirect, which could affect them, as discussed below. With the creation of the ZEC, Spain joined the group of EU countries which have decided to offer an exceptionally attractive legal and tax framework for international investments in regions classified as "ultraperipheral", namely Ireland (Dublin International Financial Services Centre) and Portugal (International Business Centre in Madeira, to be extended to Azores).

From the viewpoint of EU legislation, the granting of regional tax benefits, which may lead a company to choose a certain place to invest instead of another, may be forbidden, as a State aid, by Article 92 of the EC Treaty. This prohibits any aid granted by a Member State or through State resources in any form whatsoever which distorts or threatens to distort competition by favouring certain undertakings or the production of certain goods, insofar as it affects trade between Member States, as it is incompatible with the common market.

However, under Article 92.3 (a) and (c), the Commission may approve certain aids aimed at promoting the economic development of areas where the standard of living is abnormally low or where there is serious under-employment, as well as aids which serve to facilitate the development of certain activities or of certain economic areas, where such aids do not adversely affect trading conditions to an extent contrary to the common interest.

Based on these Community provisions, the fundamental purpose of the creation of the ZEC by Law 19/1994 was, in principle, to provide the appropriate environment for the injection of foreign capital which would contribute to the economic and social progress of the Canary Islands.

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<sup>5</sup> Law 19/1994 of 6th July 1994, concerning the modification of the economic and fiscal régime of the Canary Islands.

Nevertheless, the bill of Law 19/1994 was not submitted to the Commission until it had already been passed by the Spanish Parliament, and the mere reading of the text shows that some of the basic premises of the ZEC were highly questionable from the EU perspective, namely:

- The benefits available to companies established in the ZEC were not limited in time. The duration of those similar regimes previously approved was limited: Dublin IFSC up to year 2005 and Madeira IBC until 2011.
- The owners of the shares of ZEC companies could not be resident in Spain, unless expressly authorised to the contrary.
- As a general rule, ZEC companies were only allowed to enter into transactions with other ZEC companies or with non-residents not operating in Spain through a permanent establishment, except for the acquisition of fixed assets to be used in the activity, which could be purchased locally. Nevertheless, the Law contemplated the possibility of ZEC companies performing transactions with Spanish residents in so far as they were connected with the production of corporal goods, in the form provided by the implementing regulations to be issued.

Given that ZEC companies will qualify as fiscal residents of Spain, covered in principle by the network of tax treaties entered into by that country as well as by the provisions in the Parent/Subsidiary Directive,<sup>6</sup> the foregoing limitations could well entail a loss of tax proceeds in EU countries other than Spain, to the extent that ZEC companies, as originally conceived, could be used as a vehicle for investments in other countries but not in Spain.

In these circumstances, the EU Commission, in a Note dated 9th January 1995, raised serious reservations to the contents of Law 19/1994. This had led to the issuing of Royal Decree-Law 3/1996 of 26th January which contains important modifications to the former Law, taking into account those reservations. The comments which follow are based on the revised text of Law 19/1994, referred to as "the Law".

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<sup>6</sup> Council Directive 90/435 of 23rd July 1990, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States, O J No. L 225, p 6.

## **An Outline of the ZEC Régime, as Modified**

### **Scope of Application**

(a) Geographical

The ZEC comprises the totality of the territory of the Canary Islands, except in the cases of companies engaged in the production, transformation, handling and commercialisation of merchandise manufactured or delivered in the ZEC, which must be located in the areas to be determined by the Government of Spain, at the proposal of the Government of the Canaries.<sup>7</sup>

(b) Temporal

The ZEC régime shall apply until 31st December 1996, subject to possible extensions as well as to the initial authorisation and periodic revisions by the EU Commission.<sup>8</sup>

(c) Subjects<sup>9</sup>

The régime shall apply to those entities recorded with the Official Registry of ZEC Entities, which must meet the following requirements:

- They must have legal personality.
- They must have a registered office, the effective seat of management of their business and the main establishment within the geographic scope of the ZEC. Subject to requirements still to be known, ZEC entities will be allowed to open branches or other permanent establishments in the rest of Spain, which will not enjoy the tax benefits available under the ZEC régime.
- They must have as their sole corporate purpose the performance of the commercial, industrial or service activities contemplated in the Law.

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<sup>7</sup> Article 29 of the Law.

<sup>8</sup> Article 28 of the Law.

<sup>9</sup> Article 30 of the Law.

The exact meaning of this last requirement is still uncertain because two opposing views as to the types of activities which may be carried out by ZEC companies are being maintained. The competent authorities in the Spanish Ministry of the Treasury seem to favour a restrictive interpretation whereby only those activities specifically mentioned in the Law (namely, banks and other credit institutions, insurance companies, stockbrokers and companies engaged in the manufacture, manipulation, transformation and commercialisation of merchandise) will be allowed. Nevertheless, it is perfectly feasible to hold a broader interpretation of the legal text, which may be favoured by the Canarian authorities, according to which all industrial commercial and service activities would, in principle, be eligible.

(d) Objects<sup>10</sup>

In principle, ZEC companies are only allowed to perform transactions with other ZEC companies and with non-residents not having a permanent establishment in Spain. The implementing regulations, however, will establish specific rules concerning transactions with Spanish residents which will be statutorily authorised for companies engaged in manufacturing activities as well as the removal of restrictions for ancillary transactions.<sup>11</sup>

Nevertheless, ZEC companies may perform transactions different from those mentioned above provided that:

- (i) they are previously notified to the Management Board of the Consortium and
- (ii) the transactions in question are channelled through the permanent establishments or branches referred to in section (c) above. These transactions, however, will not enjoy the tax benefits granted by the ZEC régime.

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<sup>10</sup> Article 31 of the Law.

<sup>11</sup> Article 31.2 of the Law, which also foresees the possibility of future implementing regulations to establishing controls over specific transactions between ZEC companies and non-residents as well as requirements which non-residents may have to fulfil in order to avoid the application of the ZEC régime, directly or indirectly, to unauthorised transactions"

### **Administrative Aspects**

The ZEC will be managed by a public entity named ZEC Consortium ("Consortio"), which will be competent to approve the applications of those companies which may wish to take advantage of the ZEC and handle all the administrative aspects concerning it, including the control and supervision of compliance with ZEC rules as well as the imposition of penalties in cases of default.<sup>12</sup>

ZEC entities must be registered with the Official Register of ZEC Entities, kept by the Consortium.

### **Formation of ZEC Entities**

The formation will be subject to the Spanish legislation which may be applicable depending on the type of entity chosen, with the following requirements:<sup>13</sup>

- The number of the founding shareholders or partners may be limited to one.
- At least one of the administrators or directors must reside in the Canary Islands.
- Shares may be issued to the bearer, except those owned by Spanish residents, which must be registered.
- The minimum capital is Ptas. 1 million, except in the case of credit entities and stock brokerage firms.

The formation and registration of a ZEC entity involves the following steps:

- (a) The promoters of the ZEC entity must obtain a previous authorisation from the Consortium. The application must attach a description of the activities to be carried out as well as a certificate of deposit or bank guarantee covering the amount of the fee to be paid subsequently upon registering with the ZEC Official Registry.

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<sup>12</sup> The functioning of the Consortium and the various bodies governing it is regulated in Articles 32 to 38 of the Law.

<sup>13</sup> Established in Article 40 of the Law.

- (b) Once the authorisation is obtained, the promoters will form the ZEC entity in front of a Spanish notary public. The name of the ZEC entity must include the expression "ZEC".
- (c) The resulting notarial deed of formation must then be registered with the ZEC Official Registry. The registration process must not exceed ten days, provided that the contents of the deed conform with the information furnished in the initial application.

### **Tax Régime**

The basic principle is that ZEC entities are subject to corporation tax at the rate of 1% on the taxable income derived from their activities in the ZEC which, in principle, makes them eligible for tax treaty coverage. Income resulting from transactions carried out in any other part of the Spanish territory are not eligible for this beneficial treatment, but are taxable at the standard rate of 35%.

On the other hand, ZEC entities are exempt from any indirect taxes which would otherwise affect them, but only in respect of transactions performed in the ZEC, not on those carried out in the rest of the Spanish territory, and are entitled to a refund of the Canarian indirect general tax borne on local supplies of goods and services.

Finally, the law provides the possibility for the ZEC Consortium to enter into agreements with the municipal authorities aimed at determining a lump sum figure payable by the ZEC entities established in the corresponding territories to replace any taxes, duties or fees which would otherwise be payable.

As regards the taxation affecting the shareholders, the Law makes a distinction depending on whether they are fiscally resident in Spain or not. So far as resident shareholders are concerned, ZEC entities are deemed to fall into fiscal transparency. Therefore, these shareholders are to be imputed the portion of the taxable profits obtained by the ZEC entity, which will be taxable in their personal income tax or corporation tax, as the case may be, taking as a credit the amount of corporation tax previously paid by the ZEC entity. Tax losses are not imputable to the shareholders but may be carried forward by the ZEC entity for seven years.<sup>14</sup>

Non-residents deriving income from a ZEC entity are entitled to the benefits available to EU residents under Spanish internal legislation, which include an

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<sup>14</sup> The period may be counted as from the first year showing a taxable profit.

exemption in respect of dividends,<sup>15</sup> interest and capital gains derived from personal property.<sup>16</sup> In the last two cases, however, the benefits will not apply if the income is obtained through a tax haven.<sup>17</sup> As a counterpart to the beneficial tax treatment described above, ZEC entities become obliged to pay a fee upon their registration with the ZEC Official Registry as well as a yearly fee. The relevant amounts have not yet been determined.

Salary payments do not enjoy any special treatment, being subject to withholdings under the standard terms.

### **Special Régimes**

#### *Credit Entities*<sup>18</sup>

In accordance with the provisions in the Directive 77/780/EEC, a credit entity is defined by the Spanish internal legislation as "any enterprise having as typical and habitual activity the reception of funds from the public in the form of refundable deposits, loans, temporary transfer of financial assets, like transactions entailing a refund obligation, use of the assets for its own account, the granting of credits, or in transactions of an analogous nature".<sup>19</sup> The concept encompasses banks, savings banks and credit co-operatives.

These entities, when formed as ZEC entities, will be subject to the general requirements contained in the Spanish legislation concerning minimum capital and solvency, but will be free from the obligations applicable in the rest of the country concerning cash, investments and certain relevant ratios. The share capital must be in the form of registered shares.

In order to perform their activities, ZEC credit entities must conform with the general requirements established both in the ZEC Law and in the Spanish banking

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<sup>15</sup> Provided that the requirements established in article 46.1.(f), which implements Council Directive 90/435/EEC, are met.

<sup>16</sup> Except in the case of capital gains resulting from the disposal of shares when (i) the assets of the ZEC entity are, directly or indirectly, mainly composed of real estate or (ii) the shareholder, at any time during the twelve months preceding the transfer, has owned, directly or indirectly, at least 25% of the capital or estate of the ZEC entity.

<sup>17</sup> Royal Decree 1080/1991 contains a list of 48 countries or territories classified as tax havens.

<sup>18</sup> Articles 53 and 54 of the Law.

<sup>19</sup> Article 1 of the Royal Legislative Decree 1298/1986 of 28th June.

legislation.<sup>20</sup> The authorisation to operate in the ZEC must be granted by the ZEC Consortium, upon a favourable report from the Bank of Spain, which remains in charge of the inspection, supervision and control of the ZEC credit entities.

The Law contains specific rules guaranteeing the confidentiality of transactions and the identity of clients. These cannot be revealed except in connection with criminal proceedings or pursuant to legislation concerning money laundering. In this respect, the powers of the tax authorities are limited to reviewing whether or not the conditions permitting an entity to be a ZEC entity are satisfied.

#### *Insurance Companies<sup>21</sup>*

With a few exceptions set out in the Law,<sup>22</sup> these companies will be governed by the Spanish legislation concerning insurance activities.<sup>23</sup> The applications for authorisation as a ZEC entity, involved in specific branches of activity, will be authorised by the ZEC Consortium, upon a Report from the Ministry of the Treasury.

Premium tariffs and certain other matters will not be subject to administrative controls. The ZEC Consortium may ask for documentation to verify compliance with the applicable legislation. Furthermore, these entities will be subject to the control and supervision from the Ministry of the Treasury.

ZEC companies operating through branches in the rest of the Spanish territory will require previous authorisation from the Ministry of the Treasury.

#### *Stock Exchange and Secondary Markets<sup>24</sup>*

The Law foresees the creation of a Stock Exchange to operate exclusively in the ZEC, which will be proposed by the ZEC Consortium to the Government of Spain

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<sup>20</sup> As specified in Law 3/1994 and its implementing legislation, they include the obligation to adopt the form of a share company of unlimited duration, a minimum paid-up capital of Ptas. 3 billion, restrictions as to the identity of shareholders having a significant participation and board members etc.

<sup>21</sup> Article 55 of the Law.

<sup>22</sup> Which include the non-application of the minimum capital requirements generally imposed on insurance companies established in article 13 of Law 30/1995 of 8th November, concerning Private Insurance.

<sup>23</sup> Namely Law 30/1995 of 8th November.

<sup>24</sup> Articles 56 to 64 of the Law.

and be subject to the provisions of the Spanish Stock Exchange legislation.<sup>25</sup> The requirements for admission to quotation will be established by the future ZEC Implementing Regulations. The formation of brokerage firms, which must adopt the form of share companies, will follow the general rules. The Consortium will notify their creation to the Stock Exchange National Commission, which will be the body in charge of their control and supervision. The public issuance of shares, bonds and debentures in the ZEC, both by ZEC entities and by non-residents, will not require previous authorisations, even if made in non-Spanish currency, but will be subject to prior verification by the ZEC Consortium.<sup>26</sup> On the other hand, the Law enables the ZEC Consortium to propose to the Spanish Government the creation of official secondary markets for derivatives and raw materials, both financial and non-financial, as well as futures and options markets.

*Enterprises Engaged in the Production, Handling, Transformation and Commercialisation of Merchandise<sup>27</sup>*

The speciality of this régime lies in the requirement that the enterprises may only be established in specific geographical areas, still to be determined, which will, preferably, be located near the ports and airports of the Islands but which may also be in other convenient areas, provided that they are isolated from the rest of the territory but still well connected with those ports and airports. These areas will enjoy the treatment of free zones pursuant to the provisions in Council Regulation 2913/1992/EEC of 12th October 1992, which approved the Community customs code, and in point 8 of Decision 91/314/EEC.

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<sup>25</sup> Basically Law 24/1988 of 28th July, governing the Stock Exchange.

<sup>26</sup> Except if addressed, totally or partially, to Spanish investors, in which case the verification will correspond to the Stock Exchange National Commission.

<sup>27</sup> Article 63 of the Law.