Real Estate Going Global

Worldwide country summaries

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Going Global

Argentina

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

A foreign investor may invest in Argentine property directly or through a local corporation (*sociedad anónima*, or SA), a local limited liability corporation (*sociedad de responsabilidad limitada*, or SRL) or trusts.

At the national level, real estate rental income from properties located in Argentina is subject to a 30% income tax rate for legal entities[1] (which will reduce to 25% for taxable years beginning on or after 1 January 2021) and a scale-based rate for residents.

A withholding tax regime is applicable when paying both local and foreign taxpayers.

Real estate sales from properties located in Argentina are subject to a 15% income tax rate on the profit of the sale for individuals. However, the sale is only subject to the income tax insofar that real estate was acquired on or after 1 January 2018.

If the sale made by individuals is not subject to income tax, the property transfer tax is levied on sales proceeds. In this case, the tax rate is 1.5%.

Real estate sales from properties located in Argentina for legal entities are subject to a 30% income tax rate (or 25% for taxable years beginning on or after 1 January 2021).

Value-added tax is applicable to rents exceeding the amount of 1,500 Argentine pesos (ARS) and to construction works.

Rental incomes as well as real estate developers are subject to a turnover tax (gross income tax).

A national tax on net wealth is levied on personal assets held by local or foreign individuals.

[1] On 27 December 2017, the Argentine Congress passed a comprehensive tax reform (Law 27430), which became effective as of 1 January 2018. The tax reform includes an immediate reduction in the corporate income tax rate from 35% to 30% for the taxable years beginning on or after 1 January 2018.

Real Estate Investments

Sale of securities by non-residents

The transfer of Argentine shares made between non-residents that occurred after 23 September 2013, is subject to tax. Thus, foreign beneficiaries are subject to a 13.5% effective income tax withholding rate on gross proceeds or, alternatively, a 15% income tax on the actual capital gain if the seller's cost basis can be duly documented for Argentine tax purposes. The seller is responsible for withholding the tax for transactions made since January 2018.

Non-residents are now exempt from tax on capital gains realised from the sales of shares in publicly traded companies, but only to the extent that the shares are sold through the local stock exchange. Furthermore, non-residents continue to be exempt from tax on capital gains from the sale of sovereign bonds and corporate bonds issued in an IPO. The yields from those bonds are also exempt from Argentine tax. In all cases, the exemption is conditioned on the foreign seller being a resident in a jurisdiction that has an exchange of information agreement with Argentina and that the funds come from these jurisdictions. Only yields and capital gains derived from specific securities issued by the Argentine Central Bank (so-called LEBACs) do not benefit from this exemption. In these cases, both the income and the capital gains are subject to a 5% tax. If the tax cost cannot be determined in the case of a sale, the tax is levied at a rate of 4.5% of the sales proceeds.

Indirect transfer of Argentine assets (including shares) are taxable provided that (i) the value of the Argentine assets exceeds 30% of the transaction's overall value and (ii) the equity interest sold in the foreign entity exceeds 10%. The tax is due if any of these thresholds were met during the 12-month period prior to the sale. The indirect transfer of Argentine assets, however, is only subject to the tax to the extent those assets are acquired after 1 January 2018. Furthermore, indirect transfers of Argentine assets within the same economic group do not trigger taxation provided the requirements are met. Such requirements specify that the transfer will be considered as performed within the economic group provided that the vendor(s) of the shares have at least an 80% stake in the buyer's equity of vice versa. The operation will be also considered as performed within the economic group if one or more entities have a direct or indirect joint stake holding of at least 80% in both the acquiring and the selling company.

A withholding tax applies on dividend distributions. The current withholding tax rate is 7% and it will be increased to 13% for profits generated in taxable years started on or after 1 January 2021.

The 2018 tax reform abolished the so-called "equalisation tax" for profits generated in taxable years started on or after 1 January 2018. However, the equalisation tax still applies to dividend distributions made out of earnings accumulated prior to 1 January 2018 that exceeded tax earnings as of the year-end prior to the relevant distribution.

It is important to analyse the impact that these measures may have in structuring projects.

Rollover of fixed assets

Income Tax Law establishes that in the event of disposal and replacement of fixed assets, the gain obtained from that disposal may be applied to the cost of the new fixed asset. Therefore, the result is charged in the following years, through the computation of lower amortisation and/or cost of a possible future sale of new goods.

It is important to consider the implications of applying of the roll-over mechanism in the income tax return.

The use of real estate trusts

The use of real estate trusts is regulated by the Civil and Commercial Code, which provides a very flexible legal framework. It has been the preferred vehicle for real estate projects in Argentina and is commonly used in building construction, especially in structures where small and medium-sized investors are involved. There are no major taxation differences compared to other corporate entities.

Law 27440 established tax reductions and reduced tax rates for trusts and investment funds constituted for real estate developments, to the extent that certain requirements are met.

Real estate investment trusts should be examined as an alternative to structure real estate projects in Argentina.

Transfer pricing

All related-party cross-border payments must comply with the “arm’s length” principle. Failure to present appropriate documentation to the tax administration may result in the non-acceptance of group charges and penalties for tax purposes.

The Argentine definition of a permanent establishment (PE) comprises: a building site, a construction, assembly or installation job or supervision activities in connection therewith but only if such site, project or activities last more than six months in Argentina.

The “arm’s length” principle should be duly followed and documented. The existence of a PE should be analysed.

Tax pre-payments

In the case of declining profits, an application can be made to reduce current tax prepayments.

Cash flow models and profit forecast should be checked in order to improve liquidity by applying for tax prepayment reductions and/or refunds.

Tax treaty network

Argentina has concluded tax treaties for the avoidance of double taxation with various countries, under which reduced withholding tax rates can generally be applied on dividends, interest, royalties and certain capital gains. Currently, there are more than 20 double tax treaties signed by Argentina.

It is strongly recommended to verify substance requirements to apply double tax treaty benefits.

Tax losses carried forward

Losses may be used to offset Argentinean profits arising in the same company. Any amount of tax losses that could not be used in the year in which they were incurred can be carried forward for five years. Tax losses cannot be carried back. Losses in transfers of shares generate specific tax loss carry-forwards and may only be used to compensate profits of the same origin.

It is important to monitor taxable profits and losses during the project and when you intend to reorganise your investment structure.

Thin capitalisation rule

The deduction on interest expense and foreign exchange losses derived from financial loans with local and foreign related parties is limited to the higher amount between 30% of the taxpayer’s taxable income before interest, foreign exchange losses and depreciation and 1,000,000 ARS. The taxpayer is entitled to carry forward excess non-deductible interest for five years and unutilised deduction capacity for three years. Certain exceptions are available for the application of this rule.

Foreign exchange control regulations

From 1 September 2019, the National Executive Branch and the Argentine Central Bank issued a number of regulations which determined the restoration of the Foreign Exchange Control Regime.

In this sense, regarding incoming flows of currency in concept of financial loans, it was established that they must be brought into and negotiated in the Free Foreign Exchange Market (MLC). The fulfilment of this obligation will have to be demonstrated in order to access the MLC to pay capital and interests of financial loans. Likewise, the MLC can be accessed to pre-cancel capital or interest instalments for a maximum of three business days before the corresponding due date. A prior pre-cancelation will require BCRA approval. A specific requirement, which is prior approval of the BCRA, has been established for access to the MLC for the cancellation of capital services for financial debts taken abroad when the creditor is a related counterpart to the debtor, until 31 August 2020.

Foreign exchange regulations have also been added to the effect that to carry out any outflow of funds through the MLC, both residents and non-residents, in addition to complying with the requirements in force for each specific operation, it will be required to have the prior formal approval of the BCRA, unless the client submits a sworn declaration stating that a list of requests has been met. Among these are:

(i) the absence of available liquid external assets exceeding 100,000 USD;

(ii) all of the foreign currency holdings in the country are deposited in accounts of financial entities; and

(iii) the commitment to settle in the MLC, within five business days of its availability, those funds received abroad originating in the collection of loans granted to third parties, the collection of a term deposit and the collection of the sale of any type of asset, as long as the asset has been acquired, the deposit constituted or the loan granted after 28 May 2020.

Moreover, it has also been stipulated that for residents who seek to access the MLC to make any type of outflow of funds, a restriction to carry out operations of "*Dollar MEP"* and *"contado con liquidación"* within 90 days prior and 90 days after is applicable.

There is no obligation to bring into the country the foreign currency of capital contributions received from non-resident entities. However, non-residents who intend to access the MLC in order to purchase and or transfer abroad foreign currency (for instance for a repatriation of direct investments) shall have prior approval of the BCRA (with exception of international organisations and other official agencies with functions in the country).

Access to the foreign exchange market to make dividend payment requires prior authorisation from the Central Bank (except in the case that the local company receives a new capital contribution through the MLC, and it seeks a dividend payment of up to 30% of such new capital contribution). Central Bank's authorisations are granted on a very restricted basis.

Another topic that has been significantly modified relates to the option granted to residents – individuals and legal entities – to form foreign assets. It should be mentioned that prior to the introduction of the new set of regulations this was an alternative for both kind of legal subjects. Nowadays, only individuals may access the MLC to form external assets abroad or locally for an amount of up to 200 USD per month. To access the MLC for higher amounts, prior BCRA approval will be required.

Additionally, the individual accessing the MLC will be required to present an affidavit declaring that the funds purchased will not be used to purchase securities within five business days from the exchange transaction.

Legal entities, local governments, mutual funds, trusts and other universalities established in the country shall count with prior consent of the BCRA to access the MLC for the formation of external assets abroad or locally.

Access to the MLC by residents to pay debts and other obligations in foreign currency contracted with other residents and agreed as of 1 September 2019 onwards is prohibited, unless such obligations have been implemented through public records or deeds by 30 August 2019. In the latter case, residents will be able to access the MLC on the date in which the debt is due.

As to payments of debts arising from imports of goods and services, these can only be paid at its maturity, while pre-cancelation of the mentioned debts will be subject to prior approval of the BCRA.

For the payment of financial or commercial debts abroad in general, it was also established that it must be demonstrated that the transactions have been reported in the last due filing of the Survey of Assets and External Liabilities.

In addition, the requirement of prior approval of the BCRA will also be necessary to perform payments originated in imports of services to foreign related companies, except for certain specific concepts.

Foreign currency derived from export of goods, export of services and the sale of non-financial non-produced assets must be brought into and settled in the MLC within the terms specified for each type of these transactions.

The Exchange Control Regime gains once again extreme importance, having the BCRA emphasised that all operations that do not comply with the provisions of the exchange regulations are reached by the Foreign Exchange Regime. Consequently, in each project a careful analysis should be performed.

Corporate law impacts

In case the purchaser of land is a foreign company, the purchase of real estate may either be treated as either an "isolated act" or as an act evidencing some degree of continuous presence in Argentina. Recent administrative precedents and judicial case law tend to treat the purchase of real estate property by foreign companies under the second view and, hence, a permanent representation of the company in the country (eg, a subsidiary or a branch) may be required by the local Office of Corporations.

A local presence in the country may be needed in other to acquire real estate property.

Rural land ownership law

Pursuant to Law 26737, enacted in December 2011, foreigners shall not hold more than 15% of the total amount of land in the whole country, or in any province or municipality. An additional restriction prevents foreigners of a unique nationality from owning more than 30% within the previously referred cap of 15%. The law specifically prevents any foreigner from owning more than 1,000 hectares (approx. 2,500 acres) of rural land in the Argentine "*zona núcleo*", or an equivalent area determined in view of its location; and from owning rural lands containing or bordering significant and permanent water bodies, such as seas, rivers, streams, lakes and glaciers.

Decree 820/2016 recently issued by the Federal Government has introduced certain interpretation criteria in order to not over restrict foreign investment in rural land.

According to section 3 of Law 26737, the following persons will be considered as foreigners:

(iv) individuals with foreign nationality, despite of having their domicile in Argentina or abroad;

(v) legal persons with 51% of foreigner holding or being entitled with enough votes to control corporate will; or

(vi) legal persons with 25% of indirect foreigner holding or having enough votes to control corporate will.

Said regulation does not affect those rights acquired before the above-mentioned Law 26737 came into force.

Finally, any person acquiring frontier land (either local or foreigner) must obtain the corresponding governmental authorisation.

It is necessary to review hypothetical effects of this law in real estate investment with foreign investors.

Surface right in the new Civil and Commercial Code

A surface right involves a temporary property right on real property not personally owned, which allows its holder to use, enjoy and dispose the property subject to the right to build (or the right on what is built) in relation to the said real property. The maximum legal term for this surface right is 70 years.

The surface right holder is entitled to build and be the owner of the proceeds. In turn, the landowner has the right of ownership provided that he does not intervene on the right of the surface right holder.

The surface right terminates upon completion of the established term (or by operation of law), or by express resignation, occurrence of a condition, consolidation, or upon ten years from the last use in cases of construction. The landowner owns what is built by the surface right holder and thus, the landowner must compensate the surface right holder unless otherwise provided by agreement.

It is worth noting that this new legal mechanism is available for real estate projects in Argentina.

Simplified Companies

Law 27349 provide different new tools for developing entrepreneurial capital. Among other legal mechanisms, a trust for developing and financing such capital (FONDCE) has been created, as well as a new legal corporate type: "Simplified Companies". The referred Simplified Companies has been created for providing every entrepreneur the possibility of incorporating a company, obtaining it tax code and a bank account in a short period and with a much more flexible structure than the one in force for other legal types provided by Argentine Law 19550. Also, any existing company incorporated in Argentina under any of such existing legal types is entitled to amend its by-laws in order to adopt the Simplified Companies legal type.

It is worth noting that this new legal mechanism is available for any kind of projects in Argentina.

Limits to the property right in the new Civil and Commercial Code

The new Civil and Commercial Code establishes that the exercise of individual rights over goods must be compatible with the Collective influence rights. Such exercise must meet national and local administrative laws passed upon the public interest and must affect neither the performance nor the sustainability of flora and fauna ecosystems, biodiversity, water, cultural values, landscape, among others, according to the criteria foreseen in the particular legislation. This broad limitation over the exercise of property rights in Argentina is still to be interpreted and applied by local courts.

This a current legal concern when exercising property rights.

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Real Estate Tax Summary

General

Non-residents may invest in Australian property by direct ownership of the property from offshore, or through interposed companies, partnerships or unit trusts (either resident or non-resident).

Historically, many investments in Australian commercial property by non-residents did not require government approval. In response to COVID-19, the monetary approval threshold for which approval is required from the Foreign Investment Review Board (FIRB) has been reduced to zero Australian dollar (AUD). In addition, the Government has announced a review of the ongoing FIRB process.

FIRB rarely withholds approval except when the acquisition is of residential property or vacant land, for which stricter rules apply.

Rental income

Net rental income derived from Australian property is taxable in Australia. If the property owner is a company (whether resident or non-resident), the corporate tax rate of 30% applies. If the property owner is a non-resident individual, tax at progressive rates from 32.5% to 45% apply. If the property owner is a trust (whether resident or not), the trust itself is generally not taxed, rather the ultimate beneficiary is subject to tax, but the trustee will have to withhold tax on the distribution of the taxable income at the highest marginal tax rate. Where a trust qualifies as an Australian managed investment trust (MIT), distributions of net rental income will be subject to 15% withholding tax (WHT) if the investor is resident in an information exchange country (IEC) or 30% if the investor is not a resident of an IEC. An MIT that only hold newly constructed, energy efficient, commercial buildings may be eligible for the final 10% MIT WHT rate where construction of the building commences after 1 July 2012 and the investor is resident in an IEC.

Further information on MITs are summarised below – see section "*Managed investment trusts*".

Interest deductibility

Interest on borrowings used to acquire property is generally deductible against rental income. Thin capitalisation rules can restrict this interest deductibility. Broadly speaking, these rules restrict interest deductions relating to total debt liabilities of non-resident investors, or Australian operations controlled to the extent of 50% or more by non-residents, where the maximum allowable debt has been exceeded.

Under the rules, the maximum allowable debt is calculated as the greater of the following:

- the safe harbour debt amount;
- the “arm’s length” debt amount.

The safe harbour debt amount is currently 60% of an entity’s gross assets (less non-debt liabilities). The “arm’s length” debt amount requires the entity to determine a notional amount of debt capital that the entity would be reasonably expected to borrow from a commercial lending institution if they were dealing at “arm’s length” and certain assumptions were made.

Interest payments made by Australian residents to non-resident lenders or by non-residents with an Australian permanent establishment to non-residents are subject to 10% WHT on the gross amount of interest paid. Certain borrowings can qualify for relief from interest WHT, including borrowings under qualifying, widely held bonds, borrowing from qualifying foreign pension funds and borrowing from specific lenders, generally financial institutions, in certain countries under the relevant double tax treaties.

Interest deductions on borrowings are further subject to the Australian debt/equity rules and, in case of cross border loans, Australia’s transfer pricing rules and hybrid mismatch rules. The debt/equity rules determine the nature of a financing arrangement based on its economic substance not its legal form. The hybrid mismatch rules can prevent the deductibility of interest payments where the loan itself or one of the entities involved would other result in a hybrid mismatch of a double deduction or a deduction/non-inclusion of the interest expense and income between the borrower and the lender.

Other expenses

Other property costs incurred in deriving rental income such as insurance, property management, and repairs and maintenance (unless they constitute a replacement and are capital in nature) are also deductible.

Costs that are capital in nature, such as stamp duty and legal costs incurred in relation to the acquisition of property are generally not deductible, but form part of the capital gains cost base of the property.

Depreciation and building capital allowance

Deductions for depreciation and building capital allowances may be available against rental income.

Depreciation deductions are allowable for assets that have a limited useful life and can reasonably be expected to decline in value over the time they are used. Values for depreciation generally depend on an allocation of the purchase price of the property, which may be specified in the purchase contract, or determined by appraisers. The assets are depreciable for tax purposes generally over their useful lives, which are either self-assessed or determined by reference to tables published by the Commissioner of Taxation.

The building (or structural) part of a property may be eligible for a capital allowance write-off. No write-off is available for buildings constructed prior to 22 August 1979. For buildings constructed on or after this date, the write-off rate is either 2.5% or 4% yearly.

The building capital allowance (unlike depreciation) is always calculated on the original construction cost. The costs of improvements or extensions may also qualify.

Both depreciation and building allowances previously claimed may be recaptured on disposal if proceeds exceed the tax written down value.

Sale of property

The capital gains tax (CGT) provisions apply to the sale of property acquired after 19 September 1985 regardless of the residence of the seller. The CGT provisions can also apply to the sale by non-residents of securities held in entities that are land rich (broadly, more than 50% of the entity's gross assets by value are represented by Australian property).

From 1 July 2016, a non-final foreign resident CGT withholding regime will apply. Under this regime, a purchaser of Australian property (or securities held in entities that are land rich) may be required to withhold 12.5% tax from the purchase price paid to a foreign vendor. Where this occurs, the foreign vendor will be entitled to claim a tax credit for this amount withheld against its actual tax liability by lodging an Australian income tax return.

Real Estate Investments

Acquisition tax issues

Government approval

Australia's Foreign Investment Review Board (FIRB) is a non-statutory body established to examine proposed investments in Australia by foreign person, including the acquisition of Australian land, and advise the Commonwealth Treasurer (Treasurer) on the application of Australia's foreign investment laws – in particular, whether a proposal is contrary to Australia's national interest.

Whether a foreign person needs to obtain FIRB approval for the proposed acquisition of Australian land depends on a number of factors, including the nature of the land (eg, residential land, agricultural land, developed commercial land or vacant commercial land) and the value of the land. Australia's foreign investment laws have broad application and can also apply to the acquisition of securities in entities owning Australian land.

An application for approval must be lodged with FIRB and a no objection notice obtained prior to entering into an agreement, unless that agreement is conditional upon obtaining FIRB approval.

Upon receipt of an application and payment of the applicable fee, the Treasurer generally has 30 days to make a decision and a further ten days to communicate that decision to the foreign person through FIRB (though this time period can be extended by up to 90 days through the issue of an interim order). The Treasurer's decision may either raise no objections (allowing the proposed investment to proceed), impose conditions (which need to be met in order for the proposed investment to proceed) or, in rare cases, block the proposed investment. These timelines have been extended in response to COVID-19.

The Treasurer has the power to make a divestment order requiring a foreign person to unwind an action by disposing of the interest held in circumstances where the Treasurer was not notified of the action and determines that such action is contrary to Australia's national interest.

With the application to FIRB a fee is payable prior to FIRB considering the application. The fee level various but, as an example, for a commercial real estate acquisition in the rage between 10 million AUD and not more than 1 billion AUD, the fees amounts to 27,500 AUD.

Stamp duty

The Australian States and Territories impose a stamp duty on a range of transactions, including the acquisition of real property (at varying rate of up to 5.75%), share transfers (0.6%) and mortgages (up to 0.4% of the amount of the loan although not charged in some states). The rates vary slightly between States and Territories and many states no longer have share transfer or mortgage duties. South Australia also abolished duty on the acquisition of commercial land from 1 July 2018. Most states have higher duty rates in respect of the acquisition of residential property by non-resident investors. There are "land rich" and "landholder" rules that apply to the transfers of shares in companies or interests in trusts, where the underlying entity is predominantly invested in real estate, or where the value of real estate assets exceed a threshold (the actual tests vary between the States and Territories).

There is no stamp duty on the transfer of listed marketable securities except in limited circumstances involving the takeovers of listed land rich/landholding entities.

Goods and services tax

Goods and services tax (GST) is a form of value-added tax applied to supplies in Australia. Purchases of non-residential real property in Australia are generally subject to GST at the normal rate of 10% unless the acquisition is a supply of a GST-free going concern. The purchaser needs to be registered for GST in order to recover any GST paid.

A supply of a going concern is a supply under an arrangement under which

- the supply is for consideration;
- the recipient (ie, purchaser) is registered or required to be registered for GST;
- the supplier and the recipient have agreed in writing that the supply is of a going concern;

- the supplier supplies to the recipient all the things that are necessary for the continued operation of an enterprise; and
- the supplier carries on, or will carry on, the enterprise until the day of the supply (whether or not as a part of a larger enterprise carried on by the supplier).

A supply of a GST-free going concern means that the purchase price has no GST. The benefit of this is that it avoids the cash flow cost of the GST being passed on to the purchaser and also reduces the stamp duty cost (because stamp duty is calculated on the GST inclusive price).

The issue or acquisition of securities in an entity does not attract GST.

In the event that the investor acquires residential property:

- a purchase of new residential property is subject to GST. Usually, the GST amount is calculated based on the GST margin scheme (this means the GST included in the purchase price is less than 10%). The purchaser is not entitled to recover the GST paid if the margin scheme is used.
- a purchase of residential property (not new) is not subject to GST.

From 1 July 2018, purchasers of new residential premises or potential residential land are required to withhold an amount of the contract price and pay this directly to the tax office as part of the settlement process. This does not affect the sales of existing residential properties or the sales of new or existing commercial properties.

Vendors will generally be required to assist their purchasers to comply by notifying them whether or not they have a withholding obligation on supplies of certain kinds of residential premises and potential residential land.

The amount a purchaser must withhold and pay is generally either:

- 1/11th of the contract price (for fully taxable supplies);
- 7% of the contract price (for margin scheme supplies); or
- 10% of GST exclusive market value of the supply (for supplies between associates for consideration less than GST inclusive market value).

Purchasers do not need to register for GST just because they have a withholding requirement.

Ongoing tax issues

Net rental income

Income derived from Australian property is taxable in Australia. A deduction is usually available for property costs incurred in deriving rental income such as insurance, property management, and repairs and maintenance (unless they are of a capital nature).

Costs that are capital in nature, such as stamp duty and legal costs incurred in relation to the acquisition of property are generally not deductible, but form part of the cost base of the property for CGT purposes.

For the acquisition of a leasehold interest, the costs of stamping a lease are deductible (eg, stamp duty and legal costs).

Business capital costs

Certain business expenses are deductible over a five-year period on a straight-line basis. This includes expenditure to establish a business structure, to convert an existing business structure and expenditure incurred in raising equity.

Borrowing costs

Costs of obtaining finance, including legal costs and stamp duty on the loan transaction, are generally deductible over the period of the loan.

Interest deductibility, thin capitalisation, transfer pricing and hybrid mismatch

As noted above, interest on borrowings used to acquire real property is generally deductible against rental income subject to Australia's

- thin capitalisation rules;

- transfer pricing rules; and
- hybrid mismatch rules.

Thin capitalisation rules

The thin capitalisation rules can restrict interest deductibility where the maximum allowable debt has been exceeded. The maximum allowable debt for foreign investors, or for entities that are owned 50% or more by a foreign investor, is the greater of the following amounts:

- the safe harbour debt amount;
- the “arm’s length” debt amount.

Broadly, the safe harbour debt amount is 60% of the average value, for the income year, of the entity’s assets less non-debt liabilities. The entity’s balance sheet is used as the starting point for determining the average assets. A number of adjustments are made (which are predominantly designed to ensure that there is no “double-counting” of the 60% threshold).

The “arm’s length” debt amount is an amount the entity would reasonably be expected to borrow from a commercial lending institution if they were dealing at “arm’s length” and certain assumptions were made.

The thin capitalisation provisions apply to all debt interests (ie, third party bank debt and related party debts).

Transfer pricing rules

Where cross-border entities are involved, Australia's transfer pricing rules may apply to the interest rate used on any shareholder debt.

In assessing the commerciality of the relevant interest rate, regard must be had to the principles set out in Australia’s international transfer pricing regime, which adopt the “arm’s length” principle as described in the OECD Guidelines, being the internationally accepted standard for assessing the appropriateness of international related party transactions.

Broadly, the “arm’s length” principle requires that the terms, conditions and pricing of transactions between related parties should be the same as those that would be applied to third parties undertaking the same transactions.

Hybrid mismatch rules

In mid-2018, legislation was adopted giving effect to the OECD recommended hybrid mismatch rules. The legislation will generally apply to income years starting on or after 1 January 2019.

In simple terms, the hybrid mismatch rules seek to neutralise circumstances where cross-border arrangements give rise to payments (including, for example, interest, royalties, rent, dividends and, in some cases, amounts representing a decline in the value of an asset) that:

- are deductible under the tax rules of the payer, and not included in the income of the recipient (deduction/no inclusion or “D/NI outcome”); or
- give rise to duplicate deductions from the same expenditure (double deduction or “DD outcome”).

If an arrangement gives rise to a D/NI or DD outcome, the hybrid mismatch rules operate to eliminate the mismatch by, for example, denying a deduction or an income exemption. The rules mechanically allocate the taxation right in relation to a mismatch. The purpose of the arrangement, generally, should not affect the outcome.

For example, a tax deduction could be denied in Australia for interest paid to a foreign entity because that foreign entity is not taxed on the income it receives as a result of that foreign entity satisfying the definition of a hybrid entity. This denial would apply despite the Australian taxpayer satisfying other rules (eg, transfer pricing and thin capitalisation) and the income being subject to Australian (withholding) tax.

Debt and equity rules

The deductibility of interest may be restricted by the application of debt/equity rules. Generally, a financial arrangement will be a debt interest for tax purposes, irrespective of its legal nature, if there is a non-contingent obligation on the borrower to pay an amount to the lender that is at least equal to the amount borrowed. Where the term of the instrument is greater than ten years, a net present value calculation is required.

Depreciation and building capital allowances

Depreciation deductions are allowable for an asset that has a limited useful life and can reasonably be expected to decline in value over the time it is used.

Values for depreciation depend on an allocation of the purchase price of the property, which may be specified in the purchase contract, or determined by appraisers. Review of contracts may be required to determine these values.

Assets are depreciable over their useful lives, which are either self-assessed or determined by reference to tables published by the Australian Tax Office (ATO). Most depreciating assets can be depreciated using the straight-line or diminishing value method.

The building (or structural) part of a property may be eligible for a capital allowance. No allowance is available for buildings constructed (in Australia) prior to 22 August 1979. For buildings constructed on or after this date, the allowance rate is 2.5% or 4%.

The building capital allowance is always calculated on the original construction cost (not the purchase price) on a straight-line basis. Also, the total amount claimed by all owners cannot in aggregate exceed the original construction cost.

Both depreciation and capital allowances previously claimed may be recaptured on disposal if proceeds exceed the tax written down value (TWDV).

In the case of buildings, this recapture is part of the CGT calculation (through a reduction in cost base of amounts previously deducted). There is no CGT on depreciable assets (the difference between proceeds and TWDV would effectively be treated as income/deduction as opposed to a capital gain or loss).

There are certain rules that can apply in specific circumstances that impact on depreciation and building allowance deductions.

The Government has introduced specific instant and accelerated depreciation provisions in response to COVID-19.

Taxation of financial arrangements

Australia has had a period of significant tax reform. One such reform relates to the Australian income tax treatment of foreign currency gains and losses. The Taxation of Financial Arrangements (TOFA) provisions generally apply, subject to transitional elections, to foreign exchange gains and losses on transactions entered into on or after 1 July 2003. The timing of assessability/deductibility of financial arrangements is also governed by the TOFA rules where, subject to certain elections, the arrangement is entered into, on or after 1 July 2010. This may impact both the taxable income and compliance obligations of taxpayers.

Real estate held via a foreign entity

Where real estate is held via a foreign entity, that entity must calculate its taxable income applying Australian tax principles. The foreign entity must then pay tax on that taxable income. The rate of tax depends on the nature of the foreign entity (eg, 30% if a company).

Real estate held via an Australian entity

Where real estate is held for rental purposes, it is generally held via an Australian Unit Trust (AUT). Ordinarily, the AUT should not be subject to Australian income tax on the basis that it distributes all of its income every year.

Note that losses incurred by the trust cannot be distributed to investors. Rather, the losses are trapped in the trust.

The tax losses of a trust may be carried forward and used to offset future taxable income where the trust satisfies the 50% stake test. Broadly, this test requires a greater than 50% continuity of ownership in the trust.

There are no loss recoupment rules or limitations for a trust in respect of carried forward capital losses.

Further, revenue losses can be offset against ordinary income and net capital gains. Capital losses can only be offset against capital gains.

The taxable Australian sourced net rental income (and, in certain cases, capital gains) distributed by the AUT to a non-resident will be subject to a non-final WHT. In case of an AUT, the WHT rate depends on the nature of the non-resident investor (30% for corporate investors, 32.5% - 45% for individual investors and trusts), and on whether the AUT is an MIT or not.

If an MIT, the rate of the tax will be 15% if distributed to an IEC resident or 30% if not an IEC resident. An MIT that only hold newly constructed, energy efficient, commercial buildings will be eligible for the 10% MIT WHT rate where construction of the building commences after 1 July 2012 and the investor is resident in an IEC.

The MIT qualification requirements are summarised below – see section "*Managed investment trusts*".

If the AUT is not an MIT, the WHT is not a final tax (unlike MIT WHT), so the non-resident is required to file an annual income tax return and can claim a credit for the tax withheld by the AUT against its Australian tax liability. The non-resident will also be able to claim deductible expenditure relating to the derivation of the income from the AUT.

If the non-resident claims deductible expenditure, tax which was withheld by the AUT that exceeds the non-resident's tax liability will be refunded by the ATO.

Exit tax issues

CGT implications

Any capital gains arising from the sale of Australian real property will be included in the taxable income of the foreign investor and taxed at their marginal tax rate (30% for companies). If the sale is via an AUT, the tax treatment is as per on-going income (as summarised above – see section "*Real estate held via an Australian entity*").

Where a foreign investor disposes of securities in an entity, this will be subject to CGT if:

- the non-resident holds an interest of 10% or more in the entity; and
- more than 50% of the entity's total assets (by market value) consists of taxable Australian property (Australian real property or an indirect interest in Australian real property).

The capital gain will be included in the non-resident's taxable income and taxed at their marginal rate (30% for companies).

There are non-resident CGT WHT rules which impose a 12.5% WHT on the purchase of land or interests in land from non-residents (subject to a 750,000 AUD de minimus exemption). If a non-resident disposes of the listed Real estate investment trust (REIT) units, there is an exemption from these withholding obligations for "on-market" transactions. Otherwise, the purchase will have to withhold 12.5% of the gross purchase price for the sale of land or indirect interests in land unless the seller:

- provides an exemption certificate obtained from the ATO in respect of the sale; or
- for indirect interests in land only - provides a declaration that the relevant interest is not taxable Australian property (TAP).

GST

The vendor is generally required to include GST of 10% in the sale price, unless the property is sold as a supply of a GST-free going concern.

No GST should be applicable on disposals of interests in entities.

Stamp duty

Stamp duty is generally an obligation of the acquirer of a dutiable asset. In some states the seller and the acquirer are jointly and severally liable to stamp duty. However, the duty burden is usually commercially carried over to the acquirer.

Other Australian taxes and maintenance costs

Charges on land

Land tax

Land tax is an annual tax assessed to the owner of the land. While the imposition of land tax varies from state to state, it is generally levied on the unimproved value of land. Land tax is generally payable where the value of land exceeds certain thresholds. The rate of tax varies from state to state but could be as high as 4%.

Some States and Territories have introduced additional land tax for foreign owners of real estate or "absentee owners". This applies generally only for residential land with the exception of Victoria, where the absentee owner land tax surcharge is, subject to certain exemption, also levied in respect of commercial real estate. The additional rate of land tax in Victoria is 1.5% per annum.

Local council tax

Local councils charge landholders an annual tax called "rates". Council rates are determined with reference to the size and assessed value (as determined by the Valuer General) of a particular parcel of land. Each council applies a different formula influenced by a range of factors.

Water rates

Water rates are assessed at a flat rate imposed by the local water authority for the provision of standard services (such as sewer and water access). An additional amount is charged relative to the amount of water used on the land.

Managed investment trusts

Broadly, an AUT will be an MIT in relation to an income year where all of the following conditions are satisfied at the relevant test time:

- The AUT has a relevant connection to Australia, ie, the AUT has an Australian resident trustee or central management and control of the AUT is in Australia;
- The AUT is not a trading trust;
- A substantial proportion of the investment management activities carried out in relation to the assets of the AUT will be carried out in Australia throughout the income year;
- The AUT is a managed investment scheme (MIS) as defined in Section 9 of the Corporations Act 2001. Broadly requires the AUT to have at least two investors;
- The AUT is either registered under Section 601EB of the Corporations Act 2001, or, is not required to be registered in accordance with Section 601ED of the Corporations Act 2001 (whether or not it is actually registered);
- The AUT satisfies one of the widely held tests applicable to the AUT. Different widely held tests apply depending on the classification of the AUT as either a registered wholesale trust, unregistered wholesale trust or registered retail trust; and,
- If the AUT is not required to be registered, then the AUT must be operated or managed by:
  - a financial services licensee (a defined term) that holds an Australian financial services license and whose license covers providing financial services (a defined term) to wholesale clients (a defined term); or
  - an authorised representative of the above (authorised representative is a defined term).

Notwithstanding the above, for an AUT to qualify as a MIT:

- Where the trust is classified as a wholesale trust, ten or fewer persons (non-qualified investors) cannot hold a MIT participation interest of 75% or more in the trust.
- For other trusts, 20 or fewer persons (non-qualified investors) cannot hold a MIT participation interest of 75% or more in the trust.
- A foreign resident individual cannot have a MIT participation interest of 10% (direct or indirect) or more in the AUT.

The relevant testing times will depend on whether the AUT made a "fund payment" during the income year.

Where a trust has made a "fund payment", the testing time is at the time of the first "fund payment" in relation to the income year except for the investment management test, the trading test and the closely held test. These three tests must be satisfied throughout the income year.

A "fund payment" is broadly a distribution of the taxable income of an AUT which is attributable to Australian sources and taxable Australian property and not already subject to withholding. Distributions of net rental income or proceeds from the sale of properties are fund payments for the purposes of the MIT withholding rules.

The widely held requirement is for the trust to have either 25 or 50 (depending upon trust type) investors. There are specific investor tracing rules for the purposes of the widely held tests referred to above. That is, where a member of the trust is a qualified investor, the members will be deemed to represent a higher number of members equal to 50 times the qualified investor's percentage interest in the trust.

Note that there is no tracing through companies to ultimate investors in order to determine who is a qualifying member.

Broadly speaking, a qualified investor is a beneficiary of a trust that is:

- a life insurance company registered under the Life Insurance Act 1995;
- a foreign regulated life insurance company;
- complying Australian superannuation funds and certain pooled superannuation trusts;
- foreign superannuation funds with at least 50 members (ie, widely held pension funds);
- MITs;
- foreign equivalent of a managed investment scheme that has at least 50 members;
- a foreign government pension fund that meets certain requirements;
- foreign sovereign wealth funds or their subsidiaries that meet certain requirements;
- certain entities established and wholly-owned by Australian government agencies;
- a limited partnership that is at least 95% owned by one or more of the above "qualified investors" or their wholly-owned subsidiaries (with a general partner holding the remaining partnership interests and habitually exercising the management power of the partnership); or
- an entity that is wholly owned by one or more "qualified investors" above or their wholly-owned subsidiaries.

It is important to note that there are effectively two sets of tax rules for a MIT and its non-resident unitholders. The first relates to the liability of a foreign entity for MIT tax (the assessing provisions) and the second which requires a MIT to withhold an amount from such payments (the collection provisions).

Under the assessing provisions, where the foreign entity is presently entitled to a fund payment, then the foreign entity will be liable to tax on that share. The rate of tax applicable to that share is dependent on the residency of the foreign entity.

Under the collection provisions, where the trustee of the MIT has made a fund payment directly to an entity which has an address outside Australia, the trustee must withhold an amount from the fund payment at the rates set out below.

The key difference between the assessing and collecting provisions is that the rate of tax in the assessing provisions depends on whether the foreign entity is resident of an IEC, whereas the rate of tax for the purposes of MIT withholding depends on whether the foreign entity has an address in an IEC. Where the two countries are the same, the tax rate is the same and so the WHT becomes the only and final tax.

The foreign entity will be a resident of that foreign country where it is a resident for the purposes of the tax laws of that country. Where there are no tax laws or residency status cannot be determined, then the foreign entity will only be considered to be a resident of that country if the entity is incorporated or formed in that country and is carrying on a business in that country. See below for how the new MIT Regime rules will affect this.

The applicable tax rates are:

- if the place of payment, address or residency is in an IEC: 15%
- in any other case: 30%.
- an MIT that only hold newly constructed, energy efficient, commercial buildings will be eligible for the 10% MIT WHT rate where construction of the building commences after 1 July 2012 and the investor is resident in an IEC.

The AMIT regime

From 1 July 2016, there are broadly be three types of MITs for tax purposes:

- **Ordinary MIT**: eligible to make the MIT capital account election.
- **Withholding MIT** has the same base outcomes as an ordinary MIT but with the benefit of concessional withholding provisions in respect of certain fund payments because it has a substantial proportion of its investment management activities in Australia.

- **Attribution MIT** (AMIT) has the same base outcomes as an ordinary MIT however it is subject to the new AMIT provisions. An AMIT may or may not be a withholding MIT.

Key features of the AMIT regime relevant to real estate investors include:

- AMITs are not be subject to the existing present entitlement rules (as they would for an ordinary MIT and withholding MIT) but instead will be subject to the specific attribution rules contained in the AMIT regime.
- For ordinary and withholding MITs, the rule for determining the quantum of WHT to be withheld by the MIT is by reference to the place of payment. The final liability of the WHT is determined by reference to the tax residency of the direct MIT investor or if that investment is via a foreign trust, the tax residency of the beneficiaries of that foreign trust.
- Under the AMIT regime, if the direct investor into an AMIT is a trustee of a foreign trust, this trust will now act as the final taxpayer. That is, the final withholding liability now rests with this trust and there is no tracing mechanism to look through to the ultimate investors. This is an extension of the current treatment applied to foreign pension funds and only applies to AMITs who are also withholding MITs.
- Consequently, trusts that are located in IEC jurisdictions will need to substantiate their residency status under the tax laws of that country in order to access the 15% WHT rate.
- To the extent the trust is located in a non-IEC jurisdiction or is unable to substantiate its residency status in an IEC jurisdiction, it will no longer be able to access the 15% WHT rate if the MIT elects to be an AMIT.

Stapled entities

Stapled entities are a common feature of the Australian real estate investment market. In the case of listed property trusts, the majority of Australian REITs are in the form of stapled entities, involving two, and often more, entities in a stapled arrangement. Stapled entities are also commonly used for many infrastructure type investments.

In the case of unlisted property trusts, stapled structures are less common but are used where fund managers diversify from pure core property investment into opportunistic type investments.

Stapling occurs when two or more different securities are contractually bound together in a manner so that they cannot be traded separately. The stapling itself is implemented by means of a contractual arrangement, usually in the form of a stapling deed. Terms of stapling deeds may vary, but in essence their effect is to prevent the securities (shares or units) of the entities subject to the stapling deed from being traded separately. This is then reflected in the constituent documents of the underlying entities which provide that their securities may not be traded separately.

For legal and tax purposes, separate securities retain their individual legal character and they continue to be treated separately for income tax purposes. Accordingly, for example, if a stapled security consists of shares in a company and units in a unit trust, then the rights and obligations of the security holder as a shareholder in the company continue and similarly the rights and obligations as a unitholder and hence beneficiary of the unit trust continue.

The emergence of stapled entities has allowed REITs to retain “flow-through” tax status in relation to the holding of investment properties but at the same time allowed for internalisation of management and also for diversification of investment exposure to other property related services such as development. That is the “taxable” side of the staple undertakes non-investment activities while the “flow-through” side of the staple invests in real estate.

In March 2018, the Australian Government announced a package of tax measures, that sought to address the sustainability and tax integrity risks posed by stapled structures and limit the concessions currently available to foreign investors for passive income. Following this announcement, legislative amendments were introduced and passed by Parliament.

This new law impacts the after-tax outcomes that apply to foreign investors in certain Australian real estate investments, and not just those who invest in stapled arrangements. In particular, the new law increased the WHT rates on certain income by excluding specific asset classes from the MIT regime. It also applies this increased tax rate to cross staple arrangement where the same investors hold 80% common ownership in two or more entities (whether or not the ownership interests in these entities are bound together by a formal legal arrangement). The changes to cross stapled arrangements were motivated by the Governments intention to disallow the concessional MIT tax rates where the cross stapled income, which prima facia would qualify for the MIT rules, was ultimately sourced from active trading activities, which would not qualify for the concessional tax rates. But the proposed measures are going further than limiting stapled arrangements.

The amending legislation included the following measures:

- subjecting converted trading income to MIT withholding at the corporate tax rate (currently 30%);

- declaring income from certain assets as non-concessional MIT income (eg, residential housing and agriculture assets);
- preventing double gearing through thin capitalisation changes;
- limiting the foreign pension fund WHT exemption for interest and dividends to portfolio investments;
- creating a legislative framework for the sovereign immunity exemption; and
- ensuring investments in agricultural land and residential property (other than affordable housing) are subject to MIT withholding at the corporate tax rate.

The law should not materially impact traditional stapled REITs in the commercial and retail property sectors with little or no cross-staple lease arrangements. Unfortunately, other real estate stapled structures with cross-staple leases (ie, typically found in hotel structures) which are not generally considered a single unified business will be adversely impacted.

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Austria

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All information used in this content, unless otherwise stated, is up to date as of 24 July 2020.

Real Estate Tax Summary

General

A foreign individual or corporate investor may invest in Austrian real estate property directly, through a partnership or through a corporation.

Rental income versus business income

Rental income of individuals

Generally, income earned from the pure leasing of real estate is classified as rental income at the level of an individual or a partnership held by individuals.

Rental income is measured by the excess of earnings over income-related expenses. Expenses are deductible provided they were triggered in connection with Austrian real estate. The following deductions are allowed amongst others:

- maintenance and repairs;
- expenses for administration;
- financing costs and interest payments for financing loans;
- insurance premiums for the real estate;
- depreciation; and
- real estate tax.

Maintenance and repair costs in connection with rental income, which are not part of any acquisition or construction costs, can be offset with taxable income in the year they occur. However, there are certain restrictions and options which should be considered:

- Maintenance/repair costs, which are not part of the acquisition or construction costs, have to be spread over a period of 15 years if there is a material increase of the building value or if the expected useful life of the building is materially increased and the building is used for living purposes.
- Non-regular maintenance/repair costs (ie, costs that occur not yearly) can be spread over a period of 15 years upon application.

Furthermore, there are certain construction costs, which can be amortised over a shortened period of 15 years.

Business income

Income earned by corporations is always classified as business income. Income earned by an individual through a partnership or sole proprietorship is also classified as business income, provided the business activities go beyond pure renting or leasing out of the asset.

Any income earned by a non-resident corporate investor holding real estate in Austria is classified as business income. The same applies to a non-resident individual holding Austrian real estate in a business abroad.

Income taxation

Income tax

All individuals resident in Austria are subject to Austrian income tax on their worldwide income, including income from trade or business, profession, employment, investments, and property. Non-residents are taxed on income from certain sources in Austria only (eg, rental income). Non-residents are subject to income tax on Austrian-source income at normal rates (including a fictitious income increase of 9,000 EUR). Please find the progressive rates effective 1 January 2020 in the table below.

Income (in euro)	Tax rate (in %)
0 to 11,000	0
11,001 to 18,000	20
18,001 to 31,000	35
31,001 to 60,000	42
60,001 to 90,000	48
90,001 to 1,000,000	50
1,000,001 or more	55

Domestic and foreign corporations are taxable on their income at 25% corporate income tax. If the investment is classified as a real estate investment fund under Austrian tax law, a special tax regime is applicable (see section "*Real estate investment funds*").

Dividend withholding tax (WHT)

Dividends paid by an Austrian corporation to its domestic or foreign individual shareholders are generally subject to 27.5% WHT under domestic law. Dividends paid to corporations are subject to 25% WHT. WHT on dividends can be reduced by the application of existing double tax treaties (eg, to 5% or 15%) or by the application of the EU Parent-Subsidiary Directive to 0%.

The Parent-Subsidiary Directive is applicable, if a dividend is distributed to an EU parent company which holds at least 10% for a minimum period of one year.

Please note that anti-abuse provisions apply to the application of the double tax treaties (DTTs) as well as to Parent Subsidiary Directive. Consequently, substance (eg, employees, office space, active business) and/or functions are required at the level of the recipient of the dividend distributions.

Group taxation model

Upon application, two or more corporations may form a tax group, provided the parent company directly or indirectly owns more than 50% of the shares in the subsidiaries. The tax group also can include foreign group members. However, the scope of foreign tax group members is limited to corporations being resident in EU member states and in states that have entered into a comprehensive administrative assistance arrangement with Austria.

In order to be effective, a group must be maintained for the duration of at least three business years of each 12 months, if a group member withdraws from the group within this minimum commitment period of three years, all tax effects derived from its group membership must be reversed.

Within a tax group, all of the taxable results (profit and loss) of the domestic group members are attributed to their respective group parent. From foreign tax group members, tax losses in the proportion of the shareholding quota are attributed to the tax group parent. The foreign tax loss has to be calculated in accordance with Austrian tax law. However, it is capped with the amount actually suffered based on foreign tax law. Ongoing tax losses from foreign group members can only be recognised to the extent of 75% of the profit of all domestic group members (including the group leader). The remaining loss surplus may be carried forward by the group parent. In addition, foreign tax losses utilised by the Austrian tax group parent are subject to recapture taxation at the time they are utilised by the tax group member in the source state, or in the moment the group member withdraws from the Austrian tax group. Under the recapture taxation scheme, the Austrian tax group has to increase its Austrian tax base by the amount of foreign tax losses used in prior periods.

For the purpose of the application of the recapture taxation scheme, a withdrawal from the tax group is also assumed if the foreign group member significantly reduces the size of its business (compared to the size of the business at the time the losses arose). Reduction of size is measured on the basis of business parameters such as turnover, assets, balance sheet totals, and employees, while the importance of the respective criteria depends on the nature of the particular business.

Depreciation

Rental income of individuals

The basis of depreciation includes the acquisition costs of the building, but not the value of the land. For buildings rented for habituation purposes a general subdivision of the acquisition costs into 40% for land and 60% for building is regulated by law as of 1 January 2016. However, based on a decree issued by the Austrian Ministry of Finance, in certain cases the land share can alternatively amount to 20% or 30%. Furthermore, an exact land proportion can also be proved by an expert opinion.

The depreciation has to be calculated using the straight-line method, according to which the annual depreciation is a fixed percentage of cost. Without further proof the depreciation rate amounts to 1.5% p.a.

Business income

The depreciation rate for business property basically amounts to 2.5% p.a. However, the depreciation rate for habitual purposes amounts to 1.5%. A higher depreciation rate can only be applied in case of providing a corresponding expert opinion. The regulation regarding the subdivision of the acquisition costs into 40% for land and 60% for building does not apply to business income.

Tax-free subsidies usually reduce the acquisition costs (for rental and business income) for tax purposes and therefore also the depreciation base.

Amendments in 2020

For buildings purchased or built after 30 June 2020 an accelerated depreciation is possible. For the first year of depreciation the threefold and for the second year the twofold of the depreciation rate prescribed by tax law is applicable. Thereby the useful life is reduced by three years. In that case, buildings are always depreciated on a full year basis, even if the usage of the building amounted to less than six months (ie, in the first year of usage). The amendments are applicable for both buildings rented for habitation purposes and business property.

Interest deduction

Generally, interest payments are fully tax deductible if they meet the “arm's length” requirements.

However, for corporations there are certain restrictions for the deduction of interest payments:

Debt-to-equity ratio

Up to now, there are no formal debt-to-equity ratio requirements in Austria. However, group financing has to comply with general “arm’s length” requirements. Therefore, an Austrian group entity being financed by an affiliated entity must be able to document that it would have been able to obtain funds from third party creditors under the same conditions as from the affiliated financing entity. Therefore, the appropriate ratio between an Austrian company’s equity and debt will mainly depend on the individual situation of the company (profit and cash-flow expectations, market conditions, etc) and its industry. If an intercompany loan is not accepted as debt for tax purposes, it is reclassified as hidden equity and related interest payments into (non-deductible) dividend distributions.

According to our experience, a debt/equity ratio of 3:1 is usually accepted by the Austrian tax authorities. A higher debt/equity ratio could be applied if it can be properly documented that all financial obligations can be settled in due time. Such documentation can be done by a cash flow model/forecast which shows that there are still positive cash flows after consideration of all interest and redemption payments. Furthermore, a sufficient positive cash flow should remain in the Austrian companies for its operations.

Interest limitation regarding low-tax jurisdictions

Interest payments by an Austrian corporation to a related company are not tax deductible at the level of the Austrian corporation if

- the interest income is not subject to corporate tax on the level of the recipient because of a tax exemption; or
- is subject to a tax rate of less than 10%; or

- the effective taxation on the level of the lender is less than 10% due to specific tax incentives, among others, granted for such type of income; or
- the effective tax is below the 10% because of tax refunds including tax refunds to the shareholders of the lender.

The taxation level of the interest income has to be analysed at the level of the beneficial owner of the interest income. Therefore, an analysis is required regarding the beneficial ownership status of the lender. If the lender as recipient of the interest income is not the beneficial owner, the (effective) tax rate of the beneficial owner has to be considered.

Debt-financed acquisition from related parties

Interest expenses resulting from the debt-financed acquisition of shares are usually tax deductible. This is so even if the Austrian participation exemption regime applies.

However, interest expenses relating to the debt-financed acquisition of shares from related parties or (directly or indirectly) controlling shareholders are generally non-deductible. This disallowance of interest also applies in circumstances where the shareholder acquiring the shares has been funded by a debt-financed equity contribution (insofar as the equity contribution was made in direct connection with the share acquisition). The deductibility of interest expenses incurred in connection with the debt-financed acquisition of shares from a third party is not precluded by this rule.

EBITDA – based interest limitation rule

Article 4 of the Anti-Tax Avoidance Directive (ATAD) requires the member states of the EU to introduce interest limitation rules into national tax law by 31 December 2018. The ATAD interest cap provides that all interest expenses (from third party loans as well as from shareholder loans) are tax deductible up to the amount of interest income and, in addition, only up to 30% of the EBITDA. This rule is subject to a number of optional provisions (eg, a general exemption limit of interest expense up to 3 million EUR, a group ratio, etc).

Countries with national targeted rules for preventing base erosion and profit shifting (BEPS) that are equally effective to the ATAD interest limitation rule may apply its targeted rules at the latest until 1 January 2024. The Austrian Ministry of Finance took the position that the existing national targeted rules were equally effective as the interest cap rules under ATAD. However, in its 7 December 2018 decision the European Commission (EC) considered that the Austrian rules are not equally effective as the rules under ATAD. No separate appeal against this assessment of the EC is possible.

Therefore, in the EC's view, Austria must implement the ATAD interest barrier rules into national tax law by 31 December 2018. However, the measures should only apply to Austrian companies once they are implemented in Austrian tax law since ATAD only binds the member states of the EU but does not impose an immediate obligation on the taxpayer. If Austria is late with the implementation, several practical issues may arise, such as state aid or constitutional issues in the case of retroactive implementation. On 25 July 2019, it was announced that the EC has started an infringement procedure against Austria.

There is no draft of the ATAD interest barrier rule available. Currently, it is not foreseeable when and to which extent (eg, which exemptions are opted by the Austrian Ministry of Finance) the new rule is implemented in Austrian tax law. Due to the non-implementation of Article 4 ATAD there is also a remaining state aid risk.

Capital gains on the sale of property

Individuals

Gains from the sale of private property are subject to income tax with a special tax rate of 30%. The tax assessment base is the profit calculated using the sales price minus acquisition, construction and maintenance/repair costs (insofar not yet deducted). Tax free subsidies and depreciations are added to the sale price. Expenses in connection with the tax calculation can be deducted. Other expenses cannot be deducted.

Real estate property that is already beyond the speculation period under the former taxation regime (ie, purchase before 1 April 2002 – “old real estate assets”) are subject to special transition rules.

“Old” properties (acquisition before 1 April 2002) which were rededicated from land sites to building sites after 31 December 1987 are taxed at 18% of the sales price. “Old” properties without rededication are taxed at 4.2% of the sales price. However, in both cases the new regulation provides the option to tax the gains according to the rules for “new real estate assets”.

Losses arising from the sale of private real estate can be compensated with gains from other private real estate sales upon application. Further, 60% of the remaining losses can be offset with income from letting private property over a period of 15 years or in the same year (application necessary).

Basically, the above-mentioned tax regime for the sale of private property is also applicable for business property held by individuals. However, the transition rules are only applicable for land (and not for buildings).

Losses arising from the sale of business real estate can be compensated with gains from other business real estate sales. With regard to business property, 60% of the losses can be offset against other income and an overhang is added to the loss carry forwards.

Companies

The special tax regime is not applicable for corporations since all their profits (including gains resulting from the sale of real estate) are taxed with the standard CIT rate of 25%.

Participation exemption

Domestic dividends

Dividends received by a resident corporation from its domestic subsidiary are exempt from corporate income tax on the basis of the national participation exemption.

International participation exemption

Dividends and capital gains received by a resident company from the disposal of shares in a foreign subsidiary are exempt from corporate income tax on the basis of the international participation exemption if the participation is at least 10% for a minimum holding period of one year.

The participation exemption for capital gains can be waived by opting for a tax effective treatment of capital gains and losses from the foreign participation.

The participation exemption will not be available in cases where CFC rules apply. In July 2018, Austria introduced CFC rules for financial years beginning after 31 December 2018, whereby the former anti-abuse provision on passive income subject to low taxation was abolished. The CFC rules shall apply if

- a (directly or indirectly) controlled foreign company (ie, voting rights of more than 50%) without significant business activities;
- earns mainly (ie, more than one third) passive income (eg, interest, royalties, dividends, etc) and is
- subject to low taxation (ie, effective income tax rate of 12.5% or lower) in an EU member state or third country.

Consequently, the passive income items of the CFC will be (proportionately) added to the Austrian taxable base of the controlling Austrian company.

Portfolio dividends

In addition, dividend income received from EU Member States or third party countries with a comprehensive administrative assistance is exempt, regardless of the participation quota and the holding period.

However, under the new CFC rules for participations from 5% to 50%, a switch-over from the exemption to the credit method applies, if the foreign participation earns mainly passive and is subject to low taxation (ie, effective income tax rate of 12.5% or lower).

Loss carryforward/tax credit carryforward

Operating losses from businesses may be carried forward entirely without time limit if the losses have been calculated according to proper bookkeeping practices. Generally, no tax loss carryforwards are available for rental losses of individuals.

Tax loss carryforwards from companies can be offset against taxable income only up to a maximum of 75% of the taxable income for any given year. The remaining amount is carried forward.

Generally, there is no loss carryback available in Austria. However, due to the COVID-19 crisis a one-time carryback for tax losses incurred in 2020 to the years 2019 and 2018 will be introduced.

Real estate transfer tax

Real estate transfer tax (RETT) is generally triggered on transactions that cause a change in the ownership of Austrian real estate or in the person empowered to dispose of such property.

Direct sale of real estate

The tax rate for the direct sale of Austrian real estate amounts to 3.5%. The basis for RETT is the acquisition price. However, the taxable base has to be at least the property value (special calculation regulated in a decree issued by the Austrian Ministry of Finance). Further, in case the company is able to prove by an expert opinion that the fair market value is lower than the property value, the fair market value represents the minimum tax base.

Free-of-charge transfers

The taxable base for free-of-charge transfers (ie, family and non-family transfers) is the property value. The rate for transfers without compensation is subject to different levels. It is 0.5% for a property value of below 250,000 EUR, 2% for the property value between 251,000 EUR and 400,000 EUR, and 3.5% the portion of the property value exceeding 400,000 EUR.

Transfers of shares in companies and partnerships

RETT in the amount of 0.5% of the property value is also triggered in situations where the shares of corporations or interest in partnerships owning Austrian real estate are transferred. The following transactions trigger RETT:

- The transfer of at least 95% of the shares in a real estate owning partnership to new shareholders within a period of five years.
- The transfer of at least 95% of the shares of a corporation or a partnership to unify them at the level of one single acquiring shareholder or in the hand of several shareholders forming an Austrian tax group.

Shares held by a trustee for tax purposes will be attributed to the trustor and are therefore part of the calculation of the shareholding limit.

RETT is triggered only in scenarios where the shares of real estate owning corporations or partnerships are transferred by their direct shareholder or partners (no indirect transfer).

Transfers in the course of restructurings

For transfers in connection with corporate restructurings under the Reorganisation Tax Act, the RETT amounts to 0.5% of the property value.

Land registration fee

Additionally, there is a land registration fee in the amount of 1.1% which becomes due upon incorporation of the ownership change in the land register. The registration fee is generally assessed on the basis of the market value of the real estate concerned. However, in certain cases between close relatives, reorganisations and transactions between a company and its shareholder, the basis for the land registration fee is the threefold of the assessed standard tax value, capped with 30% of the fair market value.

Value-added tax (VAT)

VAT on rental income

Rental for residential purposes (ie, housing/living purposes) and for accommodations, such as hotel rooms, is generally taxable for VAT purposes at a rate of 10%. However, due to the COVID-19 crisis the VAT rate for the accommodation in hotel rooms was decreased from 10% to 5% in the period from 1 July to 31 December 2020.

Basically, the lease of immovable property for business purposes (not housing/living purposes) is VAT exempt without input VAT credit. However, there is a possibility to carry out an option for VAT under certain circumstances.

Option for VAT on rental income arising from letting to business tenants

Until 31 August 2012, there was the general possibility to opt for the VAT effectiveness for rental income without any further requirements. If the option for VAT is executed, the VAT rate amounts to 20%.

Since 1 September 2012, the option for the VAT effectiveness in connection with the leasing of properties for business purposes can only be exercised if the tenant uses the leased premises by at least 95% for supplies entitling him to deduct input VAT. Tenants doing business in the field of financial services (eg, banks and insurances) and doctors are generally not entitled to deduct input VAT.

The condition that the tenant has to use the leased premises by at least 95% for input VAT entitling supplies does not apply to lease agreements beginning (ie, in terms of effective use) before 1 September 2012. It is further not applicable to lease agreements concluded by the erector of a building if the erector began with the construction of the building before 1 September 2012.

If a person qualifies as an erector, the restrictions for the VAT option neither apply to lease contracts beginning before or after 31 August 2012 as long as the erector remains the lessor (ie, the erector can continue to lease the building by charging VAT without considering the status of the lessee).

However, please note that the beneficial treatment allowing an option to tax without further conditions for lease contracts beginning after 31 August 2012 for the erector of the building will be lost if the lessor changes. Such a change consequently may result in input VAT correction obligations for construction and renovation costs incurred in the last 10 or 20 years for construction and renovation cost incurred prior to 1 April 2012 and after 31 March 2012, respectively.

The same is true for buildings in the new regime which are no longer completely used for supplies fully entitling to input VAT deduction. In this case, the lessor has to correct and pay back the input VAT concerning all construction costs and renovation costs (if any) in the last 10 or 20 years annually in the amount of 1/10 or 1/20 per year.

A correction of input VAT for construction and renovation costs incurred in the last 10 or 20 years would also apply, if the building is sold VAT exempt by way of an asset deal.

Sale of a real estate

The sale of a real estate is basically VAT exempt in Austria. However, the VAT exempt sale may result in input VAT correction obligations for construction and renovation costs incurred in the last 10 or 20 years. Therefore, there is the general possibility to opt for the VAT effectiveness of such sales without any further conditions.

In the case the VAT option is executed, the VAT rate amounts to 20%. Please note that VAT increases the basis for the calculation of RETT.

Purchase of a real estate

The buyer is basically entitled to deduct the input VAT from the purchase price of the real estate property (if the option was executed).

However, if and to the extent the buyer uses the real estate or parts of it for VAT exempted activities (eg, renting of business premises without executing the option for the VAT effectiveness) an input VAT deduction is not possible.

An input VAT correction is necessary if a real estate or parts of it are no longer used for supplies fully entitling to input VAT deduction. In this case, the buyer has to correct/pay back the input VAT from the purchase in the last 10 or 20 years (for input VAT related to such costs incurred after 31 March 2012) annually at the amount of 1/10 or 1/20 per year. The input VAT correction needs only be done for the parts which are no longer entitling to input VAT deduction.

Reverse-charge regarding construction services

To tackle VAT fraud in the building and construction industry, the VAT liability resulting from the supply of construction services (ie, work on buildings) is passed from the subcontractor to the general contractor (reverse-charge mechanism for construction services). Work on buildings cover all services in connection with construction, restoration, maintenance and demolition of buildings, as well as alterations to constructions and cleaning performances. The secondment of personnel to render such services is considered as construction services, too.

According to the VAT regulation regarding construction services, the tax liability passes over to the recipient of the services under the following conditions:

- if construction services are performed by an entrepreneur, who is subcontracted to perform a construction service (eg, by a general contractor); or
- if construction services are performed by an entrepreneur who habitually renders construction services himself.

If the tax liability passes over to the recipient of the services, the invoice has to be issued without VAT. In addition, the invoice has to include the following:

- the VAT identification number of the recipient of the services.
- a reference that the recipient of the performance is liable for the VAT payable by indicating “reverse-charge”.

Inheritance and gift tax

The inheritance and gift tax was abolished in Austria in 2008. Generally, there is an obligation to notify asset transfers due to a gift transaction to the Austrian tax authorities. However, the transfer of real estate due to inheritance or gift is excluded from this announcement obligation as these transactions will be subject to real estate transfer tax.

Real estate investment funds

Austrian tax law provides for a special tax regime of real estate investment funds (thereby comprising domestic as well as foreign vehicles fulfilling certain criteria). Such regime is generally characterised by the fact that a real estate investment fund is seen as a tax-transparent vehicle with the investors being subject to tax with any income from such fund (as determined under the rules of the Austrian Real Estate Investment Funds Act) irrespective of whether a distribution has been made or not. As a result, on the level of an investor, income from a (non-Austrian) real estate investment fund comprises not only actual distributions but also so-called ‘deemed distributions.

In addition, the Austrian Real Estate Investment Funds Act provides for a specific regime (deviating significantly from general tax rules) as regards the determination of the taxable basis pursuant to which the taxable profit consists of:

(i) the ongoing profits from the underlying real estate (eg, income from leasing activities, etc minus any expenses which are determined pursuant to special rules);

(ii) 80% of the appreciation in value of the underlying real estate (independent of whether a realisation has actually taken place); and

(iii) certain investment income.

In case of non-publicly offered funds, the Austrian Real Estate Investment Funds Act provides for an increase of the tax basis as regards the appreciation in value of the underlying real estate to the full amount.

Non-Austrian resident investors holding Austrian real estate via a (foreign or Austrian) real estate investment fund are generally subject to limited (corporate) income tax liability in Austria with investment income provided such income derives from Austrian real estate thereby comprising in particular the ongoing profits as well as the appreciation in value of the underlying Austrian real estate.

Such tax liability will, however, only be triggered if Austrian real estate is held via either an Austrian or a foreign real estate investment fund in the sense of section 42 Austrian Real Estate Investment Funds Act.

Pursuant to section 42 Austrian Real Estate Investment Funds Act, a non-Austrian real estate investment fund comprises the following vehicles:

- Any alternative investment fund (AIF) in real estate unless such entity is a foreign corporation which is comparable to an Austrian corporation. However, the corporation qualifies as real estate fund, if one of the following low taxation criteria is met:
  - The foreign collective investment vehicle is in its residence state neither directly nor indirectly subject to tax which is comparable to Austrian corporate income tax;
  - Although the foreign collective investment vehicle is in its residence state subject to tax which is comparable to Austrian corporate income tax such foreign tax is lower than Austrian corporate income tax (25%) by more than 10 basis points; or
  - The foreign collective investment vehicle is subject to a comprehensive individual or factual tax exemption in its residence state.
- Any collective investment vehicle investing in real estate which is subject to a foreign jurisdiction and which, irrespective of the legal form it is organised in, is invested according to the principles of fund risk diversification

on the basis either of a statute, of the entity's articles or of customary exercise provided that one of the low taxation criteria (see above) is given.

A collective investment vehicle investing in real estate is generally assumed if – pursuant to the vehicle's purpose or the actual activities pursued – the invested capital, directly or indirectly, leads to income from the leasing or transfer of real estate.

Whether the provisions of the Austrian real estate investment funds tax regime apply will primarily depend on whether the acquisition vehicle (or any entity being a shareholder/investor of the acquisition vehicle) is to be treated either (i) as an AIF in real estate, or (ii) as a low-taxed collection investment vehicle investing in real estate with risk-spread assets.

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Real Estate Going Global

Belgium

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

A foreign corporate investor can invest in Belgian property through a local or a non-resident company, through a real estate investment fund (REIF) or through a partnership.

Foreign investors usually invest in Belgian real estate through a property company, which allows flexibility upon exit of the structure.

Rental income

Rental income is taxable in Belgium at the rate of 25% since assessment year 2021 (ie, financial year starting on or after 1 January 2020) for both local and non-resident companies.

Local and non-resident companies are, in principle, allowed to deduct costs in connection with the Belgian investment. Regional taxes (except for eg, the immovable withholding tax) and retributions are not tax-deductible.

With respect to tax deductions, several deductible elements (including incremental notional interest deduction, carry-forward dividends received deduction, and carried-forward tax losses) are only deductible up to 70% after the first 1 million EUR (the “basket system”). In other words, for those tax assets, a minimum tax base is created of 30% after the first 1 million EUR is deducted.

Note that Belgian tax law also allows, since assessment year 2020 (ie, financial year starting on or after 1 January 2019), Belgian companies (as well as Belgian establishments of foreign companies) to transfer taxable profits to other Belgian affiliated companies/establishments, with the aim to offset these profits against current-year tax losses (the “group consolidation regime”). Certain conditions are to be fulfilled for benefitting from such regime, in terms notably of percentage of shareholding, holding period, formalities, etc.

Another measure is also to be noted with respect to tax deductions, ie, the so-called “carry-back of tax losses” (which was adopted in the context of the COVID-19 pandemic). More particularly, Belgian companies (as well as Belgian establishments of foreign companies) expecting current-year tax losses in a financial year ending between 13 March 2019 and 31 December 2020 have the possibility to offset these losses against the taxable profit of the prior financial year. Certain conditions and limitations need to be considered.

Depreciation

Land cannot be depreciated. On the other hand, ancillary expenses relating to the acquisition of land can be deducted for tax purposes provided a justifiable reduction in value is booked in the year of acquisition.

Certain types of costs have to be capitalised and depreciated: office buildings at 3%, industrial buildings at 5%. A limitation may apply to the depreciation in the year of acquisition and no depreciation for tax purposes is allowed in the year of disposal.

Financing

Interest expenses related to the acquisition of real estate are, in principle, fully tax-deductible, provided that they do not exceed the market rate.

Interest paid will not be tax-deductible if the foreign beneficiary is not subject to tax or is subject with respect to the interest received to a tax regime that is significantly more advantageous than the Belgian regime. However, if the Belgian borrower demonstrates that the interest relates to effective and sincere transactions and that it does not exceed normal limits, the interest will remain tax-deductible.

Furthermore, interest expenses are subject to a thin capitalisation rule (5:1 debt/equity ratio). In this context, the tax deductibility of interest on intra-group loans granted before 17 June 2016 or on loans whereby the beneficial owner is not subject to income taxes (or, with regard to the interest income, is subject to a tax regime which is substantially more advantageous than the Belgian tax regime) paid or accrued during a given financial year will be denied to the extent that the total amount of these intra-group loans exceeds five times the net equity of the company.

Next to the 5:1 thin capitalisation rule, a specific 1:1 thin capitalisation rule needs to be monitored to avoid reclassification of tax-deductible interest into non-tax-deductible dividends (only applicable under specific circumstances).

Since assessment year 2020 (ie, financial year starting on or after 1 January 2019), and following the Belgian tax reform of 25 December 2017, net borrowing costs (to be determined based on both interest cost/income underlying intra-group as well as third party debt) are tax deductible to the extent they do not exceed either 3 million EUR or 30% of the fiscal EBITDA. Specific rules are foreseen as to how to determine the amount of net borrowing costs, the thresholds of 3 million EUR, etc, notably in the presence of other Belgian companies/permanent establishments (PEs) being part of the same group.

Belgian tax law provides, subject to certain conditions and formalities, numerous withholding tax (WHT) exemptions (eg, nominative bonds, payments to credit institutions, payments to Belgian companies etc). Furthermore, the Interest and Royalty Directive has been implemented and Belgium has an extensive tax treaty network (on the basis of which several WHT reductions are available).

Capital gains

Both local and non-resident companies are taxable on capital gains on the sale of property at the full corporate tax rate. Subject to a number of conditions (mainly reinvestment of sales proceeds), the taxation of capital gains can be deferred. The taxes on capital gains realised by foreign companies are withheld by the notary enacting the transfer deed as a professional WHT.

Capital gains on shares in the hands of corporate investors are fully exempt in case the following conditions are met: (1) participation condition (full ownership of a participation of at least 10% of the capital or worth at least 2.5 million EUR); (2) one year holding period condition (holding of the shares during at least one year); (3) taxation condition (the company which capital is represented by the shares must be subject to tax (subject-to-tax test)).

If one of the above conditions is not fulfilled, capital gains are taxable at the normal rate of 25% (20% for small and medium-sized companies (SMCs) until 100,000 EUR).

An SMC is a company that does not exceed more than one of the following criteria: 50 employees, a turnover of 9 million EUR and total asset value of 4.5 million EUR. These thresholds are to be evaluated on a consolidated level.

Real estate transfer tax and value-added tax (VAT)

The acquisition of property is subject to a 10% (or 6% for individuals acquiring their first private dwelling) or 12.5% registration duty (10%/6% for real estate located in the Flemish Region, 12.5% for immovable property located in the Brussels-Capital or Walloon Region) calculated on the higher of the contractual price or the market value.

A reduced transfer tax rate is applicable in case of acquisition of a right in rem (long lease or building right) or when the property is sold to a “professional trader”. In addition, in case of resale of the asset within the two years of its acquisition in certain circumstances, part of the transfer tax incurred can be refunded.

In the past, so-called “split-sale structures” were set-up in order to reduce the real estate transfer tax burden upon the acquisition of real estate. Such “split-sale structure” generally consisted in the split acquisition of the leasehold (long lease right) and the freehold (bare ownership) of the real estate by two related companies. However, since the implementation of the new general anti-abuse rule (GAAR) in 2012, the “split-sale structures” have been added to the so-called “blacklist” of the GAAR (a non-exhaustive list of acts which are automatically considered tax abuse by the tax authorities). Consequently, no new “split-sale structures” are being set up.

With regard to existing “split-sale structures” (set up before 2012), the exit of such structures should always be carefully analysed on a case-by-case basis (in view of the potential application of the new GAAR).

As a general rule, the sale of land and buildings as well as the rental agreements thereon are exempt from VAT without input VAT credit.

However, the Government has issued a legislative proposal on the possibility for landlords to apply VAT on certain immovable lettings. The newly expected rules which are planned to enter into force on 1 January 2019 (with a possibility for landlords to already opt as from October 2018), comprise inter alia:

- The possibility to apply VAT on lettings (only in a B2B context) is open to newly constructed or newly “sufficiently renovated” buildings (and accompanying land) for which the construction starts after 1 October 2018.

- Short-term leases of (old or new) buildings or land of maximum six months will de jure be subject to VAT in a B2B context.
- The possibility to apply VAT on (old or new) warehouse lettings to the extent that over 50% of the building is used for warehousing purposes. Moreover, the current rules will be more flexible and part of the VAT letting would also be possible if a part of the building is used for retail (10% maximum).

The VAT group regime offers opportunities to limit the VAT leakage in case of VAT-exempt letting.

The sale of a company's shares is generally not considered a sale of the property itself.

Real Estate Investments

Introduction

Investors wishing to invest in Belgian real estate will have various options to structure the acquisition. Basically, the choice will be between a direct acquisition of an asset ("asset deal") and an indirect acquisition, ie, a purchase of shares in the company that owns the targeted asset ("share deal").

Rather than actually participating in the management of properties, some investors may also wish to obtain return on property through purely financial investments (transferable securities). For these investors, Belgium offers a number of interesting options such as real estate certificates (BRECs) and shares in closed-end real estate investment companies such as public Belgian real estate investment trusts (REIT/SIR/GVV) or institutional Belgian real estate investment funds (REIF/FIIS/GVBF).

The consequences and characteristics of these various solutions are analysed below, together with some tax and legal features regarding the construction of a new building.

General anti-abuse measure

Belgian tax law provides for a general anti-abuse measure for corporate income tax, registration duties and inheritances purposes.

Under this provision, a legal deed (or set of legal deeds) is not binding on the tax authorities if they show that there is tax abuse. For the purposes of the anti-abuse rule, "tax abuse" is defined as:

- a transaction in which the taxpayer places himself – contrary to the purposes of a provision of the Income Tax Code (ITC)/Registration Duties Code/Inheritance Tax Code (or related Royal Decree) – outside the scope of that provision;
- a transaction that gives rise to a tax advantage afforded by a provision of the ITC/Registration Duties Code/Inheritance Tax Code (or related Royal Decree) whereby conferral of that tax advantage would be contrary to the purposes of that provision and securing the tax advantage was the essential goal of the transaction.

If the tax authorities find that a legal deed or a set of legal deeds can be considered as tax abuse, it is up to the taxpayer to prove that the choice of that legal deed or set of legal deeds was motivated by reasons other than tax avoidance (reversal of the burden of proof). If the taxpayer cannot prove this, the transaction will be subject to tax in line with the purposes of the respective tax law, as if the tax abuse had not taken place.

The application of this anti-abuse rule should be analysed on a case-by-case basis. In July 2012, the tax administration has published a circular letter (so-called "blacklist") with respect to the presence or not of tax abuse in the context of registration duties and inheritance tax. This non-exhaustive list of acts which can be considered tax abuse includes the so-called "split-sale structures" (see above).

Acquisition of real estate

Asset deal – Direct tax aspects

The basis for depreciation in general is the historical cost of the asset, ie, the acquisition price (as referred to in the acquisition deed), plus related costs (registration duty, brokerage fees, notary's fees, architect's fees, etc).

The tax-deductible annual depreciation rate will usually be 3% for office buildings, houses and apartments, and 5% for industrial buildings.

In the year of acquisition of an asset, only the pro rata of an annuity can be accepted as depreciation for income tax purposes. In the past, this limitation only applied to companies that could not be considered as small and medium-sized companies (SMCs) as defined by Article 1:24 24 of the Belgian Code on Companies and Associations. With respect to assets acquired on or as from 1 January 2020, this pro rata regime of depreciation also applied to SMCs.

According to the position of the central tax administration, no depreciation can be accepted for the year in which the asset is disposed of.

Ancillary expenses incurred at the time of acquisition can only be depreciated in the same way as the asset to which they relate – so no full deduction in the year of acquisition. On the other hand, ancillary expenses relating to the acquisition of land can be deducted for tax purposes provided a justifiable reduction in value is booked in the year of acquisition.

In the hands of the seller (corporate entity), any capital gain realised upon the disposal of immovable property will be taxable at the standard corporate income tax rate of 25% up to assessment year 2020. The realised capital gain can be reduced by the respective selling costs, financing costs, running costs, notional interest deduction and tax losses carried forward which are available at the level of the seller. The taxation of the capital gain can be deferred under certain conditions (mainly reinvestment – see below).

Asset deal – Indirect tax aspects

Registration duties

Whether resident or non-resident, the purchaser of a property located in Belgium must register the deed evidencing the transfer of the property. The registration duty is 12.5% or 10% (6% in Flemish Region for individuals acquiring the first private dwelling), depending on the location of the immovable property, in principle calculated on the selling price (ie, the price agreed upon by the parties).

The taxable basis for a transfer of full ownership cannot be lower than the market price. The market price is defined as the selling price that could be obtained in the open market from a potential purchaser fully aware of all the circumstances (fair market value). Where the selling price is proven to be artificially low (sham), the tax authorities are empowered, under certain conditions, to impose a penalty on the purchaser and on the seller equal to the amount of the tax evaded.

When certain formalities are complied with, the above registration duties can be partially recovered (3/5 in the Walloon and Flemish Region; 36% in the Brussels-Capital Region) if a property is resold within two years of its acquisition. Instead of this recovery, it is possible in the Flemish Region to carry forward these registration duties for the future transfer tax due on a new acquisition of a single private residence located in the Flemish Region.

A 4% (5% in the Walloon Region and 8% in the Brussels-Capital Region) reduced rate will apply in the Flemish Region to purchases by corporate entities (or individuals) whose business activities mainly consist of buying and selling real estate, ie, merchant traders. Merchant traders will have to provide evidence that they qualify by carrying out successive sales within the five years following their application for recognition. In particular, the reduced rate is only available if the property is sold within eight years (ten years for the Walloon Region and the Brussels-Capital Region) following the year of purchase, and the sale attracts registration duties at the standard rate of 10% or 12.5%.

In addition to transfer tax, a notary's fee is due on the transfer value of real estate at rates ranging from 0.057% to 4.56%.

VAT

As a general rule, the sale of land and buildings, as well as the rental agreements thereon are exempt from VAT without input VAT credit. There are, however, a number of exceptions.

Under certain conditions, the supply of new buildings (including adjoining land) can be subject to VAT instead of registration duties. As of 1 January 2011, the supply of land that belongs to a new building or part of a new building is indeed subject to VAT insofar as the supply of the building itself is subject to VAT (see above). The VAT regime will apply to sales, granting and transfer of rights in rem on new buildings or so-called VAT leasing of new buildings where certain conditions are met.

The supply of a "new" building is subject to VAT if the seller is a so-called building constructor, or a taxpayer, or a private person who has opted to supply the new building under the VAT regime. It is not the purchaser who decides whether or not the sale will take place under the VAT rules.

If the supply/acquisition is carried out under the VAT regime:

- the supplier will have input VAT credit on (most) relating costs/investments; and
- the purchaser will be entitled wholly or partly to deduct the input VAT insofar as the purchaser uses the building as part of those of the purchaser's economic activities that are subject to VAT.

An asset deal not subject to VAT could trigger a VAT revision. VAT revision period are 25, 15 or 5 years depending on the type of costs and situation of the building.

No VAT revision is applicable if the asset deal constitutes a going concern for VAT purposes.

Specific VAT revision rules also apply in case of sale of a building where the optional VAT letting is applied.

Asset deal – Legal and environmental aspects

The right of ownership

Under Belgian civil law, ownership is defined as the right to enjoy and dispose of assets in the most absolute way, provided that no use is made thereof that is prohibited.

The scope of the ownership of real estate is governed by the following three principles:

- Ownership of land includes ownership of the ground and of the subsoil.
- Ownership of land includes all the proceeds and income deriving therefrom.
- Ownership of land includes ownership of all that is attached to it; this is the so-called principle of accession.

From a legal viewpoint, accession is a method of acquiring ownership whereby the owner of a principal asset becomes the owner of all that is annexed thereto.

According to this principle, the owner of a plot of land or building becomes the owner of any constructions erected on their estate and of any improvements or transformations made to the building, regardless of the identity of the person who erected the building and/or the ownership of the building materials. Exception to this rule can be made, allowing buildings to be erected on a property owned by a third party.

Private sales agreement, notary deed and registration

The purchase of a property is made by the conclusion of a sales agreement governed by the rules of general law. According to these rules, there is a sale as soon as there is an agreement between vendor and purchaser on the asset sold (even if that asset does not yet exist) and on the price (even if the price is ascertainable, albeit not yet determined).

However, the sale will require a written contract for the purposes of evidencing the transaction and payment of the registration duties. This written contract may be drafted privately, ie, without the intervention of a public notary. It is then commonly called a “private sales agreement” (*compromis*). This is the document that actually sells the real estate, but it is not the same as the notary deed by which the transfer is made effective.

The private sales agreement is only enforceable between the parties. In order to be enforceable vis-à-vis third parties, the sale must be registered at the Mortgage Registry, ie, by means of an entry in the register (*transcription/overschrijving*). Subsequently, the sale will be registered at the Land Registry (*cadastre/kadaster*) for real estate tax purposes.

As only duly certified deeds (and judgements) may be entered in the mortgage register, the sale must be recorded in a notary deed. Since the registration duty needs to be paid at the latest four months after the signing of the private sales agreement, it is advisable to have the sale recorded in a notary deed within a term of four months following the private sales agreement. The notary deed is then produced for entering in the register by the public notary.

The client is free to choose its notary. In case seller and purchaser appoint a different notary, the two notaries will share the fees relating to the deed between them. The choice of a notary by each of the parties will therefore not entail any increase in costs for the buyer.

Environmental and town planning aspects

Over the last few years, Belgium has faced a substantial increase in the number of laws, acts and decrees in the fields of environment and town planning. The fact that the legal framework in these matters vary from one region to another makes it even more complicated for real estate investors. We have outlined below the most significant impacts of this legislation on real estate investment.

Permits

Building permit

In the three regions, prior to the demolition, construction, external, substantial refurbishment or modification of the function of a building, in most cases a building permit must be obtained.

Performing these works without a building permit or in contradiction with the plans and/or the conditions provided by the building permit and, in some cases, maintaining it constitutes a breach to the applicable town planning laws. In some cases, the purchaser of a building can be held liable for the illegal works performed before its acquisition.

In the Flemish Region, the building permit (*stedenbouwkundige vergunning*),the environmental permit (*milieuvergunning*), the socio-economic permit (*socio-economische vergunning*) and the permit for vegetation changes (*vergunning voor vegetatiewijzigingen*) are included in one integrated environmental permit (*omgevingsvergunning*).

For mixed real estate projects, the issue of permits therefore consists in one single application, one single public enquiry and one single consultation round, resulting in one single integrated decision by the authority granting the integrated environmental permit.

Integrated environmental permits are, in principle, awarded for an indefinite period of time. The parties will also have the possibility to consult with the relevant authorities before the application of a permit and to change the project even after the investigation period or during an appeal in order to make the project compliant with the applicable laws and regulations.

For the mixed projects in the Walloon Region, ie. projects that require both an environmental and building permit, a “single permit” (*permis unique*) is required. The “single permit” incorporates both a building and environmental permit. Only one permit application must be submitted, which will be assessed by a single authority in order to obtain a single permit.

In contrast to the Flemish and Walloon Region, the Brussels-Capital Region does not have an integrated permit, ie, containing both building and environmental permit. Therefore, the mixed projects in the Brussels-Capital Region require for the time being two separate permits. Even though two permit application files will have to be submitted, both application files will be examined simultaneously by the permit granting authorities.

Environmental permit

In each region, an environmental permit (*milieuvergunning*) has to be delivered for buildings where activities or installations harmful for the environment are operated and located. The concerned activities and installations have been listed in implementing decrees.

If the building is sold, the change of operator must be notified to the relevant authority. The absence of notification can impact the liability of the former and new operators, and can be subject to criminal and administrative fines, depending on the region where the activities/installations are located.

As described above, in the Flemish Region the environmental permit (*milieuvergunning*) is included in the integrated environmental permit (*omgevingsvergunning*).

For the mixed projects in the Walloon Region, a “single permit” (*permis unique*) is required. The “single permit” incorporates both a building and environmental permit. Only one permit application must be submitted, which will be assessed by a single authority in order to obtain a single permit.

In contrast to the Flemish and Walloon region, the Brussels-Capital Region does not have an integrated permit, ie, containing both building and environmental permit. Therefore, the mixed projects in the Brussels-Capital Region require for the time being two separate permits. Even tough two permit application files will have to be submitted, both application files will be examined simultaneously by the permit granting authorities.

Socio-economic permit

The socio-economic permit is required for setting up one or more retail trades with a net surface area of more than 400 square meters, which is accessible to the public. Previously, the socio-economic permit was governed by the federal law of 13 August 2004 regarding the permit of commercial establishments. As a result of the Sixth State reform, the authority relating to the permit for commercial establishments were transferred to the Regions. As a result, each region has adopted its own regulations in this area.

In the Flemish Region, pursuant to the Decree of 15 July 2016 on the Integral Commercial Establishment Policy, the socio-economic permit has been integrated into a single permit for retail activities as of 1 August 2018.

In the Brussels-Capital Region, the Ordinance of 8 May 2014 merged the retail permit with the building permit as of 1 July 2014.

In the Walloon Region, the Decree of 5 February 2015 introduced a “commercial establishment” permit subject to similar conditions as of 1 July 2015.

Town planning

Each region has adopted a comprehensive set of land allocation plans. These plans are enacted at regional, provincial and municipal levels. They can cover the whole territory of a region, province or municipality or only a part of it.

A land allocation plan divides the covered territory into various parcels of land for which a specific use (eg, residence, industry, services) is prescribed. The plans can also prescribe specific provisions related to the configuration (eg, maximum height) and the activities performed in the building located within a block.

While granting a building, environmental or socio-economic permit (cf. an integrated environmental permit), the permit delivering authority has to comply with the provisions of the land allocation plans. Even though some exception may apply. These plans are also enforceable for the authorities granting the environmental permits.

It can be pointed out that in the Flemish Region, the Decree on Complex Projects, which entered into force on 1 March 2015, provides for an integrated and optional procedure for projects that require an integrated environmental permit and a spatial planning process for rezoning the area. This decree therefore foresees, once a project is approved, the implementation of both a rezoning and the necessary permits via a single integrated process.

Soil formalities

In the Flemish Region and the Brussels-Capital Region, the acquisition of a plot of land or of the premises can be subject to the performance of prior soil formalities, as described below. The Walloon Region enacted new legislation regarding soil pollution by adopting the Decree of 5 December 2008 regarding the management of contaminated land. The implementing decrees were on hold for many years. Eventually, on 1 March 2018, a new Decree was adopted. It was published on 22 March 2018.

Soil formalities – Flemish Region

The Flemish Soil Sanitation Decree is aimed at safeguarding the quality of the soil in Flanders by imposing a duty to clean up the soil in cases where a critical level of soil pollution is reached. This obligation is imposed on the operator, the owner or the person having control over the soil.

Since 1 October 1996, before transferring a piece of land, the transferor has to provide the transferee with a “soil certificate”. This certificate is issued by the Flemish Waste Management Authority (OVAM) and provides the transferee with information on such soil pollution as is known to OVAM. Furthermore, a preliminary soil investigation is required before any transfer of land on which potentially polluting industrial activity is (or was) carried out (cf. the activities listed in annexe 1, VLAREBO) (“risk” lands). On the basis of the results thereof, OVAM may require a second, more thorough investigation to be carried out, in order to determine the exact extent of the pollution.

If a critical pollution level has been reached, the transfer will only be allowed if the transferor draws up a soil sanitation plan, gives a formal commitment to clean up the land and offers adequate financial guarantees covering their obligations.

These obligations apply to all transactions relating to a “transfer of land” as defined by the Flemish Soil Sanitation Decree. This concept not only refers to the transfer of ownership but also comprises for example concession agreements, operations vesting or terminating limited rights in rem: usufruct (*usufruit/vruchtgebruik*), long leases (*droit d’emphytéose/erfpachtrecht*), building rights (*droit de superficie/opstalrecht*), Business operations – mergers or demergers, etc.

Any breach of these obligations carries criminal, administrative and/or civil liabilities. Moreover, the purchaser and OVAM may apply for the annulment of the transfer.

On 8 December 2017, the Flemish Parliament approved an amendment to the Soil Sanitation Decree. The amendment decree appeared in the Belgian Official Gazette on 2 February 2018 and most provisions came into effect 10 days after the publication.

The amendment contains some important changes to the Flemish soil policy. For example, there will be a mandatory soil investigation moment for uninvestigated “risk” land with potentially historic soil contamination and the generalised declaration of conformity of soil surveys will be abolished. These changes are an important step in ensuring that the remediation of all contaminated land in Flanders is started by 2036.

Soil formalities – Brussels Capital Region

General

The Brussels-Capital Region enacted its initial legislation regarding soil pollution by means of the Ordinance of 13 May 2004, which has been altered by the Ordinance of 5 March 2009 regarding the management of

contaminated land. The executive orders of 17 December 2009 and 16 July 2015 determine a list of “risk activities” (polluting activities that might pose a risk to the soil).

The Soil Management Ordinance comprises two chapters, one related to the information and the second one related to the management of contaminated lands. The soil sanitation is considered a management measure among others.

For gas stations, there is a specific procedure as implemented in the order of 21 January 1999.

On 13 July 2017, the “Ordinance amending certain provisions of the Ordinance of 5 March 2009 regarding the management of contaminated land” was published in the Belgian Official Gazette. These changes entered into force on 24 July 2017. This reform relates to three areas: administrative simplification, acceleration of procedures and finally, optimisation of the financial support of owners who have not caused the pollution of their site themselves.

Information
The information system put in place by the Ordinance of 5 March 2009 is based on an “inventory of contaminated lands or of lands which could be presumed contaminated”. A third party such as a buyer or lessee only has access to a limited part of the data of the inventory. They are only entitled to access the entire information with the express agreement of the owner or holder of a real immovable right.

Before transferring a piece of land, the transferor has to provide the transferee with a “soil certificate”. This certificate is issued by the Brussels Institute for the Environment (BIM) and provides the transferee with information on such soil pollution as is known to BIM.

The performance of a soil investigation is required in various specific cases, such as an accident or an accidental discovery of soil/groundwater pollution, prior to the transfer of a land whereupon a “risk activity” is or has been performed and before the transfer of the corresponding environmental permit, etc.

The soil investigation must be performed by the transferor of a real immovable right listed in the inventory, by the transferor of the environmental permit, by operator or the person liable for the accident.

Pollution management
If the soil investigation reveals pollution, a “risk investigation” has to be performed by the persons mentioned above. The risk investigation must determine the risk level occurred by the soil pollution for human health and for the environment considering the concrete use of the land or its appropriation in the allocation plan. The risk investigation must also determine if decontamination is required and/or if conservatory measures can be taken. The sanitation of the site is considered a measure among others, eg, containment or pollution management.

Under the Soil Management Ordinance, a clear distinction is made between “new”, “historical” and “mixed” pollution and the related liabilities for owners and operators are more clearly stipulated.

Any breach of the obligation set forth in the Brussels Ordinance carries a criminal penalty. Moreover, the purchaser may apply for the transfer to be annulled.

Soil formalities – Walloon Region

On 1 March 2018, a new Decree regarding soil management and soil remediation was adopted. It was published on 22 March 2018. This Decree aims at an integrated approach, to preserve the quality of the soil, to prevent the threats to the soil, to address land degradation and to promote sustainable soil This new Decree allows the full implementation of the previous soil legislation but makes it more adaptable.

As of 1 January 2019, the transferor of property must, before transferring a piece of land, provide the transferee with an extract from the Soil Condition Database. The content of this extract must be included in the sale agreement.

The transfer of land is not included in the new decree as a fact that imposes soil obligations. The fact that no soil obligations are imposed in the case of a transfer of land was deemed necessary by the legislator in order to avoid blocking or delaying property transactions. However, this does not prevent the parties themselves from deciding to voluntarily carry out an exploratory study in order to be better informed about the state of the soil on the transferred parcel.

If the extract from the Soil Condition Database would show that the land is considered to be polluted or potentially polluted, and in case the transferor has already been required by the administration to carry out soil obligations, the agreement or deed relating to the transfer of land must stipulate whether the execution of the soil obligations will remain the responsibility of the transferor or, where appropriate, that those obligations shall be transferred to the transferee. In the latter case, the transferor and the transferee must jointly notify the administration, which may then demand that a security be provided for the execution of these obligations.

Energy performance regulations

The Flemish Region, the Walloon Region and the Brussels-Capital Region have moreover enacted comprehensive legal frameworks regarding the energy performance of a building, which impose different obligations together with some information duties to be complied with within the framework of a transfer of a property, depending on its location.

The Flemish Government has made these energy performance certificates mandatory when residential buildings are sold or rented. An energy performance certificate is mandatory for public buildings. Since 1 January 2020, an energy performance certificate is also required for the sale and lease of small non-residential units.

Upon sale, the energy performance certificate must be transferred to the new owner. Upon lease, a copy of the energy performance certificate must be added to the lease agreement.

In the Walloon Region, the Decree of 28 November 2013 concerning the energy performance of buildings and its Executory Decree of 15 May 2014, came into force on 1 May 2015. This Decree contains the minimum energy performance criteria for buildings and gives the Walloon Government the power to introduce mandatory “energy performance certificates”. The transferor of a residential building or unit has to be in possession of an energy performance certificate and provide it to the transferee before the conclusion of a sale or lease-agreement. In addition, buildings with a total usable area of more than 250sqm occupied by a public authority and frequently visited by the public, must be in possession of an energy performance certificate.

In the Brussels-Capital Region, the Ordinance of 2 May 2013 enacting the Brussels Code of Air, Climate and Energy Control provides for the general principles and specific provisions on air and climate, which entered into force as of 1 January 2015 with regard to the EPB part and the corresponding executory decisions. In relation to the transfer of certain residential or office units, the holder or the transferor of the rights to the property has to be in possession of a valid energy performance certificate. This includes sale, partial sale, leasing, transfer of lease, conclusion of an immovable leasing contract, transfer of a right in rem or the establishment of a right in rem, with the exception of mortgages, mortgage settlement, marriage contracts and their amendments. The EPB certificate has to be provided to the transferee and included in the deed of the real estate transaction. Public buildings also require ”energy performance certificate public building”.

Share deal – Direct tax aspects

Capital gains on shares in the hands of corporate investors are fully exempt in case the following conditions are met: (1) participation condition (full ownership of a participation of at least 10% of the capital or worth at least 2.5 million EUR); (2) one year holding period condition (holding of the shares during at least one year); (3) taxation condition (the company which capital is represented by the shares must be subject to tax (subject-to-tax test)).

If one of the above conditions is not fulfilled, the capital gain will be taxed at the normal rate of 25% (20% for SMCs until 100,000 EUR).

Please note that the tax authorities could try to challenge the application of the tax exemption on the capital gain in case the share deal would constitute tax abuse.

Besides a number of exceptions (eg, in case of transfer of a significant shareholding to an investor resident outside the European Economic Area, or EEA), capital gains are in principle not taxable in the hands of private individual investors. Therefore, the sale of the real estate company will usually be more advantageous to the seller than the sale of just a property.

However, contrary to what happens in the case of a direct purchase, the purchaser will not benefit from any step-up on the asset, which will keep the tax value it previously had. As a result, according to our experience, the purchase price for the shares of a company owning real estate is usually determined, taking into account a discount of 50% of the standard corporate tax rate (ie, 50% x 25% = 12.5%) on the difference between the fair market value of the property and its tax value (ie, on the “profit latency”).

The deduction of tax losses, the investment deduction carried-forward and the non-used part of notional interest deduction within Belgian companies is disallowed in case of a change in control of the company, unless this change can be justified by legitimate financial or economic needs which are to be assessed in the hands of the company with such tax assets. Neither the Belgian tax legislator nor the tax authorities provide for extensive guidelines on the issue when a change of control could be considered meeting “legitimate financial or economic needs”. The Belgian ruling commission has, however, issued a substantial number of rulings on this issue where the tax attributes can be carried forward in case it concerns genuine operations for which the activity is continued after the change of control, and for which the employment is not substantially affected by the change of control (this question is less relevant for a real estate company with no personnel).

It is worth underlining at this stage that tax-free restructurings (mergers, splits, partial demergers, or contributions of a line of business) are possible in Belgium (provided certain conditions are met).

The EU Merger Directive has been implemented into Belgian tax law in 2009. Belgian tax law hence provides a tax-neutral regime for cross-border reorganisations.

Share deal – Indirect tax aspects

From an indirect tax viewpoint, in principle, the sale of a company is not subject to registration duties, whatever the type of assets held by that company. One should however be aware of the fact that the sale of shares in a property company has already been challenged by the tax authorities, who considered in some extreme cases that the intention of the contracting parties was obviously to sell the property itself rather than the company. The authorities consequently tried to levy the 12.5%/10% registration duty on the transaction. This risk of application of the new general anti-abuse measure (see above) should always be assessed on case-by-case analysis.

The sale of shares is not subject to VAT (unless re-characterisation or simulation would occur).

Share deal – Legal and environmental aspects

From a legal viewpoint, the transfer of shares in a Belgian company is not subject to major procedures: if registered shares in a limited liability company are involved, they are transferred by a declaration of transfer recorded in the share register. Similar procedures are required for other forms of business organisations.

Neither the notification of a change of operator (environmental permit), nor soil formalities are applicable in case of share deals. Nevertheless, the new shareholder must be aware that they may have to confront the soil legislation at a later stage, ie, because of the periodical obligation to carry out a soil investigation, or when accomplishing a transaction considered as a “transfer of property”.

Construction – Direct tax aspects

From a direct tax viewpoint, the erection of a building does not raise any specific issue. It should however be noted that the (acquisition) cost of the building may include any direct or indirect cost, including, for instance, architects’ fees, consultants’ fees, non-deductible VAT and even interest charges incurred for financing the construction up to the moment that the building is ready to be used.

The capitalisation of all construction costs will allow the company to avoid incurring significant losses during a period when the asset is not producing any income.

Construction – Indirect tax aspects

In the process of planning the construction of a building, the VAT status of the transactions will be of significant importance. The main issue at that stage will be to determine the extent and timing of the building constructor’s right of deduction.

The exercise of the right of deduction depends on the building constructor’s status and the intended final use of the building.

- If the building constructor is a professional developer, the building constructor is entitled to deduct upfront input VAT on (most of the) relating costs/investments. Input VAT will not need to be pre-financed by the developer. A professional developer can be defined as any person who regularly supplies or intends to supply new buildings for consideration, or transfer rights in rem on new buildings that were acquired or constructed under the VAT regime. They are registered VAT payers and their supplies of new buildings, as well as the rights in rem on new buildings transferred by them, are always subject to VAT. The professional developer may have to perform a correction of the VAT deducted if the building is not sold with VAT within a certain timeframe.
- If the building constructor is not a professional developer, they must opt for taxation in order to be allowed to supply (eg, sell) the building with VAT. Input VAT will be deducted at the time the building constructor sells the building with application of VAT. VAT will need to be pre-financed by the building constructor.
- The reduced VAT rate of 6% is applicable on renovation works on private dwellings, under conditions.
- The reduced VAT rate of 6% is also applicable on the demolition of a building followed by the reconstruction of a private dwelling in certain cities.
- Reduced VAT rates of 6% and 12% are applicable in other specific cases (social housing, etc).
- Immovable work services are subject to the reverse charge mechanism in Belgium (provided certain conditions are met). As a consequence, immovable work services’ providers are often in a VAT refund position. In order to mitigate the pre-financing of the VAT, such services’ providers are allowed to ask the refund of the VAT on a monthly basis.

Construction – Legal aspects

Permits

One of the basic issues before erecting a building in Belgium is obtaining the necessary permits, ie, building permit, and, in case of mixed projects, an environmental and/or, a socio-economic permit. This primary step is usually very expensive and time-consuming, but each region has adopted simplified application procedures (see above), which made it cheaper and less time consuming to obtain the required permits.

The contractor's status

A principal/contractor can be held jointly and severally liable with his/her contractor/sub-contractor for outstanding tax and/or social security liabilities. The principal/contractor can be relieved from such liability by retaining certain amounts on the invoices to be paid. Whether the principal/contractor can be held jointly and severally liable depends on whether the contractor/sub-contractor has outstanding tax and/or social security liabilities at the moment of signing the contracting agreement. As on 1 September 2012, the mandatory registration of contractors has been abolished, the tax and social security status of such contractors can currently only be verified via two public databases, held by the Belgian social security authorities (RSZ) on the one hand and the Belgian tax authorities on the other.

The amount to be retained for tax liabilities is the lower of 15% of the amounts invoiced (excluding VAT) and the tax liability outstanding as confirmed in a certificate issued by the relevant authority and the amount to be retained for social security liabilities is the lower of 35% of the amounts invoiced (excluding VAT) and the social security liability outstanding as confirmed in a certificate issued by the relevant authority. Under the 22 December 2008 Finance Act, invoiced amounts of less than 7,143 EUR are not subject to the certification requirement (de minimis rule) and in principle will trigger the 15% retention. This means that the amount to be retained on invoices lower than 7,143 EUR will be 15% of the invoiced amount and not the amount of the tax liability outstanding as confirmed in a certificate issued by the relevant authority in the event that this amount would be lower than 15% of the invoiced amount. A similar rule already applies to social security withholdings.

New legislation has been enacted at federal level on 16 April 2012 which regulates (amongst other) the following: (i) in the context of the joint liability of the principal/contractor for social security and tax liabilities, a principal/contractor can now also be held liable for the social and tax liabilities of all sub-contractors going down the chain; and (ii) a principal/contractor can be held jointly liable with its contractor/sub-contractor in the context of the payment of the salaries by the (sub-) contractor(s) to its employees.

Letting of real estate

Indirect tax aspects

Registration duties

The transfer of a long lease right (which is a right in rem of at least 27 years) is subject to a registration duty at the rate of 2% on the transfer price increased with the remaining lease instalments.

Registration is also in general required for lease agreements, if not subject to VAT. A reduced rate of 0.2% applies in case of a regular lease agreement (rental agreement).

VAT

The letting of real estate is mostly VAT exempt with no input VAT deduction. The table below however shows the exceptions to this rule. These exceptions can be subject to specific conditions that are not detailed here.

Type of letting	VAT treatment
Letting of immovable property	VAT exempt
Letting of parking spaces (not linked to a VAT exempt letting contracts)	Subject to VAT
Letting of (old or new) warehouse to the extent that over 50% of the building is used for warehousing purposes and part of the building is used for retail (10% minimum)	Subject to VAT
Letting of furnished accommodation in hotels, motels and establishments providing accommodation to paying guests	Subject to VAT

Letting of camping spaces	Subject to VAT
Letting of immovable property in operating ports, harbours and airports	Subject to VAT
Letting of permanently installed equipment and machinery	Subject to VAT
Short-term letting of (old or new) buildings or land of maximum 6 months will de jure be subject to VAT in a B2B context	Subject to VAT
Real estate leasing contract (strict conditions)	Subject to VAT
Letting (only in a B2B context) of newly constructed or newly "sufficiently renovated" buildings for which the construction starts after 1 October 2018. Optional regime.	Subject to VAT

Operating real estate company

Taxation of real estate and deductions

Resident investors

It should be noted that there are no significant differences in the way companies and individuals using a real estate for business purposes are taxed. The Belgian tax regime is therefore presented under the same headings for both. Note, however, that the taxation of individuals owning real estate that is affected to non-business purposes is fundamentally different.

The starting point for determining taxable income is the company's annual accounts. Some adjustments are, nevertheless, made in order to bring the figures in line with the tax accounting rules. Among these adjustments are the disallowed expenses, the addition of provisions not immediately deductible for tax purposes, or any other necessary adjustments to the assets and liabilities.

Resident companies are subject to the standard corporate tax rate of 25% (the additional crisis contribution no longer applies since 1 January 2020). Reduced rates are available in some cases (mostly if privately owned and if low taxable basis).

The company's income can, as a result, be reduced by tax-deductible expenses connected with the real estate such as depreciation of buildings (depreciation of land is in principle not possible), repairs, maintenance, renovation and similar costs, interest on loans taken out to finance the acquisition of real estate, immovable WHT, etc. Regional taxes – except for those listed in Article 3 of the Special Communities and Regions Finance Act of 16 January 1989 (eg, property immovable WHT) – and retributions are not tax-deductible, including penalties, increases, expenses and late payment interest, relating to these non-tax-deductible taxes and retributions.

Belgian companies/branches can claim a tax deduction for their cost of capital by allowing them to deduct for tax purposes a notional (deemed) interest on their equity (the so-called "notional interest deduction", or NID). The equity is the amount reported in the Belgian generally accepted accounting principles (GAAP) balance sheet at the end of the prior year established in execution of the Belgian Code on Companies and Associations. However, in order to avoid double use, some items have to be deducted from the starting base (eg, participations, treaty branch assets less treaty branch liabilities, revaluation reserves, etc).

Since 2018, the NID is calculated based on the increase of the risk capital in the last five years (incremental NID). Excess NID (ie, the NID that is not compensated with benefits of the year) cannot be carried forward. The "stock" of excess NID stemming from the years before assessment year 2013 may still be carried-forward for seven years (with certain limits as regards the amounts). Please note that both incremental NID and the stock of excess NID are subject to the "basket system" since 2018. According to this system, several deductible elements (including incremental NID, carry-forward dividends received deduction, and carried-forward taw losses) are now only deductible up to 70% after the first 1 million EUR. In other words, for those tax assets, a minimum tax base is created of 30% after the first 1 million EUR is deducted.

The rate of the NID is based on the average of the ten-year Belgian Government bonds rate. The NID-rate to be applied is 0.746% for assessment year 2020 (financial year ending as of 31 December 2019 or later). Please note that the NID-rate should be increased by 0.5% for SMCs.

Please note already that with respect to assessment year 2021, the rate of the NID is expected to be nihil for large companies. Indeed, the rate will in principle to be determined based on the average return of the 10-year Belgian government bond in the month of July, August and September 2019. For these months, the average return was however of negative. This is however still to be confirmed by the Belgian tax authorities. With the exception of land, most tangible and intangible assets can be depreciated for tax purposes. The depreciation methods allowed for tax purposes are the straight-line and the declining-balance methods. However, the declining-balance method is not

allowed where the use of the asset has been transferred to a third party (eg, renting). It is the original acquisition cost that is generally the basis for depreciation, and the depreciation rate should be based on the normal useful life of the asset. That said, the Belgian tax authorities provide for depreciation rates that are acceptable from a tax point of view. The annual depreciation rate of real estate generally ranges between 3% (eg, office buildings) and 5% (eg, warehouses and operational real estate) of the property's investment value.

Capital gains that are merely reflected in the company's accounts but not realised (revaluation surpluses) are in principle temporarily tax-exempt, provided that an amount equal to the revaluation surplus is booked on a separate account on the liabilities side (tax-free reserve). The depreciation of the revaluation surplus, however, will be considered as a disallowed expense and consequently be taxable. After realisation of the asset, this taxation is compensated by a lower (taxable) capital gain (ie, timing difference).

Taxes are required to be paid on a prepayment basis at quarterly intervals over the course of the business year. If no or insufficient tax prepayments are made, from assessment year 2021 (financial year as per 31 December 2020 or later) a 6.75% tax surcharge becomes payable at the time the taxes are finally assessed. The timely made tax prepayments can normally be deducted from such surcharge at the rates of 9%, 7.5%, 6% or 4.5% depending on whether they have been made respectively in the first, second, third or fourth quarter of the year. Due to COVID-19 effects, the rates related to the third and fourth prepayments have recently been increased to respectively 6.75% and 5.25%. This supportive measure is however limited to certain companies, ie, the ones ending their financial year between 30 September 2020 and 31 January 2021, not having distributed any dividends, and not having reduced their share capital.

Tax returns are to be filed annually, in principle no later than six months after the accounting year-end. The tax will then be assessed by the authorities on the basis of the information provided in the tax return and become payable at the latest, two months after the assessment.

The normal assessment period is three years as from the first day of the assessment year. However, this period may be extended to seven years (as of January 2009) in cases of fraud. The assessment period of three/seven years is also applicable for the professional, movable and immovable WHT (except in Flanders, where the assessment period for immovable WHT is five years). In relation to property companies (which are often in a loss-making position during the initial years of business), it should be noted, however, that the tax authorities can question the amount of tax losses carried forward in the assessment year they are used. The amount of the tax losses carried forward can therefore be adjusted by the tax authorities in the year of utilisation (even if exceeding the three-year term).

Interest expenses related to the acquisition of real estate are, in principle, fully tax-deductible, provided that they do not exceed the market rate.

Interest paid will not be tax-deductible if the foreign beneficiary is not subject to tax or is subject with respect to the interest received to a tax regime that is significantly more advantageous than the Belgian regime. However, if the Belgian borrower demonstrates that the interest relates to effective and sincere transactions and that it does not exceed normal limits, the interest will remain tax-deductible.

According to the (general) thin cap rule (5:1 debt/equity ratio), the tax deductibility of interest on intra-group loans or on loans whereby the beneficial owner is not subject to income taxes (or, with regard to the interest income, is subject to a tax regime which is substantially more advantageous than the Belgian tax regime) paid or accrued during a given financial year will be denied to the extent that the total amount of these intra-group loans exceeds five times the net equity of the company. An anti-abuse rule states that, if the loans are guaranteed by a third party or if loans are funded by a third party that partly or wholly bears the risk related to them, the third party is deemed to be the beneficial owner of the interest, if the guarantee or the funding has tax avoidance as its main purpose.

Since assessment year 2020 (ie, financial year starting on or after 1 January 2019), this general thin cap rule only remains applicable for intra-group loans granted before 17 June 2016 (for which no fundamental changes occurred) as well as for loans whereby the beneficial owner is not subject to income taxes (or, with regard to the interest income, is subject to a tax regime which is substantially more advantageous than the Belgian tax regime)

For the other loans (both intra-group and third-party loans), these are since assessment year 2020 (ie, financial year starting on or after 1 January 2019) and following the Belgian tax reform of 25 December 2017 subject to the so-called 30% EBITDA limitation rule. According to the latter, net borrowing costs are tax deductible to the extent they do not exceed either 3 million EUR or 30% of the fiscal EBITDA. Specific rules are foreseen as to how to determine the amount of net borrowing costs, the thresholds of 3 million EUR, etc, notably in the presence of other Belgian companies/PEs being part of the same group.

Besides the aforementioned interest tax deductibility limitation rules, the specific 1:1 thin capitalisation rule also needs to be monitored to avoid reclassification of tax-deductible interest into non-tax-deductible dividends (only applicable under specific circumstances). This applies if the interest is paid upon a loan granted by a private individual holding shares of the recipient of the loans or by a person (private individual or foreign corporate body) to a company in which he has a position as director, business manager, liquidator or any similar position. This re-

characterisation applies when the interest exceeds the market rate or when the loan exceeds the sum of the amount of (fiscal) capital at the end of the financial year and taxed reserves at the beginning of the financial year and, in both cases, only to the extent of that surplus.

Belgian tax law provides, subject to a number of conditions and formalities, numerous WHT exemptions (eg, nominative bonds, payments to credit institutions, payments to Belgian companies etc). Furthermore, the Interest & Royalty Directive has been implemented and Belgium has an extensive tax treaty network (on the basis of which several WHT reductions are available).

Losses related to real estate can be offset against any other income. Tax losses may in principle be carried forward indefinitely. As mentioned above, the NID cannot be carried forward.

As already mentioned, Belgian tax law provides since assessment year 2019 (ie, financial year starting on or after 1 January 2018), for a basket system. We also refer to the above regarding (i) the group contribution regime and (ii) the carry-back measure.

The Belgian tax regulations require that transactions between related parties, including domestic or foreign companies, should be carried out on an “arm’s length" basis. In cases where the tax authorities consider that an “abnormal or gratuitous benefit” has been granted in a transaction with a foreign-related company or a company located in a tax haven country, to the detriment of the Belgian company’s profits, they will seek to increase the taxable basis of the Belgian company.

Article 207 ITC (in conjunction with Article 79 ITC) prescribes that when a Belgian tax-resident company or branch receives abnormal or benevolent advantages from a related company, these advantages cannot be offset against the carried forward and the current year tax losses, the carried forward and current year investment deduction, the carried forward and current year NID, the dividends received deduction and the patent income deduction. Moreover, according to the tax authorities (based on a parliamentary question), any abnormal or benevolent benefit received constitutes the minimum taxable basis for the company having received such a benefit.

Non-resident investors

The mere fact that a foreign company holds or leases real estate in Belgium means that it has a taxable presence in Belgium. However, such taxable establishments are generally not considered to be a permanent establishment (PE) in Belgium within the meaning of most double taxation treaties, unless it actively carries on real estate business in Belgium.

The profits of the Belgian establishments of foreign companies are not subject to corporate income tax but to non-resident income tax. Nevertheless, to a large extent, the determination of the taxable profits of a Belgian branch is subject to the same rules as for a Belgian company. However, no deduction may be claimed for interest or royalties paid by a branch to its home office, or to another branch of the same company (except when the specific funds used in Belgium are raised by the foreign company or branch from a third-party lender).

If the non-resident company that owns the Belgian real estate operates through a PE, a reasonable portion of the foreign home office’s overhead expenses can qualify as deductible expenses for Belgian tax purposes. This will not be the case if the non-resident company does not operate through a PE in the sense of the double tax treaty, ie, if real estate transactions are not the company’s main activity. In such a case, only those charges directly relating to property management will be deductible from the Belgian income base.

As is the case for resident companies, the tax rate applicable to non-resident companies is 25% (the additional crisis contribution no longer applies since 1 January 2020).

Please note that non-resident investors can also benefit from the NID, irrespective of having a legal branch in Belgium. In case the taxpayer is not obliged to prepare Belgian generally accepted accounting principles (GAAP) accounts, he can however benefit from the NID if he spontaneously establishes annual accounts and keeps accounting books in compliance with Belgian GAAP.

Sale of real estate (exit)

Asset deal – Direct tax aspects

Corporate income tax

Capital gains realised by Belgian companies or branches of foreign companies on the sale of land, buildings or equipment are taxed at the normal corporate income tax rate, ie, 25% (29.58% up to assessment year 2019 included).

Note that the non-resident companies are subject to a WHT on the capital gain realised. This professional WHT is withheld by the public notary who registers the transfer deed and only constitutes a prepayment, as it may be offset against the final corporate tax bill.

In order to calculate the capital gain, the agreed price for the property reduced by the costs linked to the sale should be compared to the tax book value of the latter (ie, historical cost less tax-deductible depreciation and/or write-offs, plus any taxed revaluation surplus) at the beginning of the accounting period during which the sale will take place.

Nevertheless, a deferred taxation of this capital gain is possible. Only the net capital gain is however considered. The costs made in order to sell have to be deducted from the capital gain. Indeed, provided that the company can prove that it has held the tangible fixed asset for more than five years prior to its disposal, taxation of the capital gain can be deferred, provided the full sale, exchange or contribution proceeds (not only the capital gain) are reinvested in qualifying assets. This regime is optional.

In case of reinvestment, the taxation is spread following the depreciation period of the asset(s) in which the realisation proceeds are reinvested. The advantage of the regime is the positive timing difference. The longer the depreciation period of the asset(s) in which the realisation proceeds are reinvested (eg, reinvestment in buildings), the lower the net present value of the tax charge will be.

The application of the deferred taxation regime is subject to the following conditions (summarised):

- Reinvestment of the total realisation value of the tangible fixed assets in new or second-hand depreciable tangible or intangible fixed assets (land is therefore excluded) that are used in EEA countries.
- The reinvestment should be made in depreciable assets; the way this reinvestment is paid (financing by cash, by shares, or takeover of debts) is not relevant. In this respect, a qualifying reinvestment can be made in the form of acquisition of full ownership of a real estate property, or the conclusion of a long-lease agreement (payment by cash), a contribution (issue of new shares), a taxed contribution of universality (payment made partially by the issue of new shares and partially in the form of takeover of debts from the contributor company). It is however of the utmost importance that the (depreciable part of the) assets contributed or acquired are at least equivalent to the amount of realisation.
- Reinvestments should take place within a delay of three or five years, depending on the asset(s) in which the realisation proceeds are reinvested.
- The capital gain should be recorded on a blocked reserve account on the liabilities side of the balance sheet and should not be taken into account to calculate the annual appropriation to the legal reserve or any remuneration or attribution. The blocked reserve account is transferred to the P&L account to the extent that the capital gain concerned becomes taxable.
- An appropriate form 276 K (commitment to reinvest) should be annexed to each of the corporate income tax returns relating to the financial year of realisation of the capital gain and to each of the subsequent financial years until the capital gain concerned is fully taxed.

If all the above conditions are complied with, the taxation of the capital gains is spread over the depreciation period (allowed for tax purposes) of the asset(s) that is acquired to fulfil the reinvestment obligation. The blocked reserve account is transferred to the profit and loss (P&L) account to the extent that the capital gain concerned becomes taxable. Deferred taxation occurs at normal corporate income tax rate.

Ultimately, the capital gain, which has not yet been taxed on the basis of the depreciation of the reinvestment, will be immediately taxed upon the disposal or the discontinuation of the reinvested property.

In order to avoid substantial tax increases, sufficient tax prepayments must be made in the year the capital gain, or part of it, becomes taxable.

The sale of the real estate may then be followed by the liquidation of the Belgian company, in order to repatriate the sales proceeds to the shareholders. The amount of the distribution exceeding the paid-up capital (liquidation surpluses) qualifies from a tax point of view as a dividend and is subject to a 30% WHT. As from assessment year 2015, SMCs can benefit from a reduced taxation of 10% on distributions by the creation of “liquidation reserves” (under certain conditions).

Treaty protection or the Parent-Subsidiary Directive may still offer relief.

Capital losses realised on the sale of real estate are fully tax-deductible.

Individual tax

In principle, capital gains realised on the dwelling home are not subject to taxation.

Capital gains realised on a built immovable property sold more than five years from its acquisition will, in principle, be exempt while capital gains realised on a built immovable property sold less than five years from its acquisition will in principle be taxed at 16.5% (to be increased by municipal taxes).

The same 16.5% tax rate applies on capital gains realised upon the sale of a property by the beneficiary of a gift if the sale occurs within three years of the donation of the property and within five years after its acquisition by the donator for a valuable consideration.

Capital gains realised on land sold within eight years after its acquisition for a valuable consideration are taxed at 33% (16.5% when sold after five years but within eight years after its acquisition). The same tax rates apply on capital gains realised upon the sale of a land by the beneficiary of a gift if the sale occurs within three years of the donation of the property and within eight years after its acquisition by the donator for a valuable consideration.

Furthermore, notwithstanding the above, a separate tax rate of 33% can apply if speculation is successfully invoked by the tax authorities.

Asset deal – Indirect tax aspects

Regarding the indirect tax aspects of the sale of property, see section "*Acquisition of real estate*".

Asset deal – Legal aspects

Regarding the legal aspects of the sale of property, see section "*Acquisition of real estate*".

Share deal – Direct tax aspects

Corporate income tax

Capital gains on shares in the hands of corporate investors are fully exempt, subject to conditions (see above).

Please note that the tax authorities could try to challenge the application of the exemption in case the share deal would constitute tax abuse.

Capital losses realised on such sales are not deductible, except where the company is wound up, and even then, only up to the amount of the loss of paid-up capital of the liquidated company.

Individual tax

Capital gains realised by Belgian resident individuals on shares that are not held for business purposes are in principle tax-exempt, unless the transfer of the shares cannot be regarded as falling in the scope of the normal management of one's private estate. If the transfer of the shares cannot be regarded as falling in the scope of the normal management of one's private estate, any capital gains will be taxable at 33% (to be increased by municipal taxes).

Also, the capital gains realised by Belgian resident individuals upon the transfer of shares will be taxable at 16.5% (plus municipal taxes) if the following cumulative conditions are met:

- The transferor owned, at any time during the five years preceding the transfer, alone or with close family members, more than 25% of the shares of the Belgian company of which the shares are sold.
- The transfer is for a consideration.
- The transfer is made to a company or an association that does not have its registered seat or principal place of business in a country located within the EEA.

Note that transfers of such shares to third parties to avoid the application of the 25% participation rule followed by a subsequent transfer (within 12 months) to a foreign company located outside the EEA will be hit by this taxation as well.

Capital gains realised by individuals on the sale of shares held for business purposes are normally taxed at the general progressive income tax rate. A separate tax rate of 16.5% (to be increased by municipal taxes) applies if the shares were held for more than five years. The minimum holding period of five years is not applicable in the case where the capital gains are realised at the occasion of the complete and definitive end of the professional activities, or of a branch thereof.

Taxable capital gains on shares realised by individuals can benefit from a temporary exemption to the extent they are realised at the occasion of a merger, a demerger, or another qualifying corporate restructuring, or a contribution of the shares to an EU company. The taxation will then occur upon the future disposal of the shares.

Share deal – Indirect tax aspects

Registration duties

The sale of shares in a real estate company will in principle not be subject to registration duties. Please refer however to the chapter relating to the acquisition of real estate (in particular regarding the risk on an application of the sham theory or the general anti abuse provision).

VAT

The sale of shares is a VAT exempt operation.

Share deal – Legal aspects

Regarding the legal aspects of the sale of shares, we refer to the chapter relating to the acquisition of shares.

Special real estate investment vehicles

The Belgian real estate investment fund (B-REIF)

The real estate investment fund (REIF) – *fonds d'investissement immobilier spécialisé*, (FIIS)/*gespecialiseerd vastgoedbeleggingsfonds* (GVBF) – dedicated to professional and institutional investors has recently been introduced into the Belgian legal and regulatory framework via the Royal Decree of 9 November 2016 (Royal Decree). The REIF is a non-listed real estate alternative investment fund benefiting from a flexible legal and regulatory regime and from a beneficial tax regime.

The REIF regime provides for an asset management platform dedicated to real estate funds in Belgium. Secondly, the REIF can be used as a holding structure to pool real estate assets or segregate real estate assets from an institutional investor such as a commercial or industrial group or an insurance company.

Regulatory regime

One of the most noteworthy characteristics of the REIF is the flexible and light regulatory regime, as it is open to institutional and professional investors willing to invest in real estate (as specifically defined in the Royal Decree).

Please note that the REIF regime is an optional regime and only specific entities defined under Belgian legislation might opt-in. The REIF is a closed-ended fund and no offer to the public nor any admission to trading are authorised.

In principle, the REIF qualifies as an alternative investment fund pursuant to the European alternative investment fund managers (Directive 2011/61/EU, the AIFMD). As a consequence, the manager of the REIF is subject to the Belgian rules on alternative investment fund managers implementing the AIFMD into Belgian legislation. However, depending on the structure of the REIF and of its shareholders/investors, it might benefit from certain exemptions and exceptions. For instance, in some cases, the REIF having a single shareholder/investor (sole investor) might be considered as out of scope of the AIFMD.

This should be analysed on a case by case basis.

The REIF is not subject to any prudential supervision. A simple registration procedure with the Ministry of Finances (*SPF Finances/FOD Financien*) will have to be complied with. This will ensure a fast operability of the REIF and limit start-up costs.

The REIF does not have to comply with any diversification obligation or leverage ratio, nor with any minimum share capital amount other than that provided for by the Belgian Code on Companies and Associations.

A minimum of 80% of the adjusted net result of a REIF must be distributed to its shareholders by means of dividends.

Tax regime

Belgian companies entering into the REIF regime will be subject to an exit tax of 15% (rate applicable to operations carried-out as from 1 January 2020) on its latent capital gains on Belgian real estate and untaxed reserves (depending on the operation at hand). This exit tax will also apply in case of any later acquisition of Belgian real estate through a contribution in kind, merger or partial demerger.

During its lifetime, the REIF will however not be subject to Belgian corporate income tax with regard to its real estate income (rental income and capital gains) Indeed, the REIF is subject to corporate income tax, but it benefits from a special tax status as the taxable income of a REIF is limited to the abnormal or benevolent advantages received and the non-deductible expenses. The latter do not include the reductions in value on shares and capital losses realised on shares.

The REIF is subject to the Belgian annual tax of 0.01% on its net asset value to the extent it is held by Belgian investors.

The REIF can benefit from the Belgian double tax treaties (including the relevant withholding tax reductions and exemptions).

Furthermore, an exemption of withholding tax (normally 30%) is foreseen for dividends distributed by the REIF to a foreign investor to the extent such dividends include foreign source income. For foreign investors the REIF would thus be tax transparent for investments in foreign real estate.

Finally, a withholding tax exemption is foreseen for any dividend distributed by the REIF to a foreign pension fund.

For more details of the tax regime of the REIF, we refer to the below section in relation to the REIT, as the tax regime is principally the same.

Accounting

The statutory accounts and the consolidated accounts (if any) of a public and an institutional REIT are to be drafted according to IFRS. A specific reporting scheme is provided for by the legislator.

Under IFRS, real estate investments have to be recorded in the books at fair market value.

The Belgian real estate investment trust (B-REIT)

The regulated real estate company (*société immobilière réglementée*/*gereglementeerde vastgoedvennootschap*, or REIT) has been introduced in 2014 into Belgian legislation. The REIT regime has replaced the former regime of the so-called SICAFI (ie, all former SICAFI have been transformed into a REIT).

The REIT is not considered as an undertaking for collective investment and is not being caught by the AIFMD or any other fund regulation.

Provided certain regulatory requirements are met, the Belgian Financial Services and Markets Authority (FSMA) can grant the REIT status to a new or an existing company.

A company that has obtained the REIT status is subject to corporate income tax, but its taxable basis is very limited. Its regulatory regime includes (i) the rules applicable to any listed company and (ii) specific rules related to its real estate investments.

Regulatory regime

Only a public limited liability company (*société anonyme*/*naamloze vennootschap*) and a partnership limited by shares (*société en commandite par actions*/*commanditaire vennootschap op aandelen*) are eligible for the REIT status. Both of these entities are corporate bodies and have a separate legal personality according to Belgian company law.

The Belgian law on REITs foresees three types of REITs: a REIT can be “public”, “institutional” or “social”. The public REIT is a regulated and licensed listed company raising its capital by means of public offers on a regulated market and having a free float of minimum 30%. It has to be noted that the persons “acting in concert with the promoter of the public REIT”, ie, the person(s) managing the REIT, are not deemed to be part of the public and, hence, their shares are not to be considered as part of the free float.

Next to real estate in the broad sense, the public REIT is also eligible to invest in various types of infrastructure projects, such as public-private partnerships, concessions or utility networks.

The institutional REIT is a regulated and licensed non-listed company. The institutional REIT’s investors need to be professional or institutional investors (*investisseurs éligibles*/*in aanmerking komende beleggers*) or private investors that invest at least 100,000 EUR. Previously, an institutional REIT needed to be exclusively or jointly controlled by a public REIT (ie, at least 50% + 1 of the shares of an institutional REIT had to be held by a public REIT). Due to the new reform, it will be sufficient that at least 25% of the share capital of an institutional REIT have to be held by a REIT.

As mentioned above, public and institutional REITs are subject to a prudential supervision of the FSMA and must be licensed in order to receive their REIT status. Once licensed, public and institutional REITs are listed by the FSMA on the register of REITs. This register can be consulted on the website of the FSMA.

Moreover, the REIT must comply with some requirements and restrictions:

- according to the REIT legislation, the REIT must have a fully paid-up share capital of at least 1.2 million EUR. However, additional share capital requirements are provided for by the rules related to the listing on Euronext Brussels Stock Exchange;
- since the shares of the public REIT will be offered to retail investors on a regulated market, a prospectus will need to be approved and published, containing sufficient information to enable the public to take well-informed decisions;
- share buy-back is allowed under certain conditions;
- annual evaluation of the real property by an independent expert;
- limited amount of authorised activities (ie, investing in real estate, or in infrastructure projects);
- a public REIT must diversify its assets in order to spread the investment risks between the geographical area, the investment type and the category of tenant;
- a public REIT may not act as a mere property developer (ie, constructing buildings itself or having them constructed in view of selling them);
- a public REIT's debts cannot exceed 65% of its assets;
- minimum of 80% of the net result of a REIT must be distributed to its shareholders by means of dividends;
- public and institutional REITs are subject to the reporting requirements mentioned in the Belgian Code on Companies and Associations, such as the deposit with the National Bank of Belgium of the annual statutory and consolidated accounts together with the annual report.

The social REIT was introduced in 2017 to social regulated real estate companies having the company form of a cooperative company with limited liability with a view to the financing of real estate infrastructures relating to the social sector, such as care for the disabled, elderly and children. The social purpose of these investments shall be ensured via specific rules (regarding authorised activities, company form, debt ratio of 33%, company liquidity, profit distribution) deviating from the ordinary regime of public regulated real estate companies.

Tax regime

Like REIFs, REITs are subject to corporate income tax, but they benefit from a special tax status. Indeed, the taxable income of a REIT is limited to the abnormal or benevolent advantages received and the non-deductible expenses. The latter do not include the reductions in value on shares and capital losses realised on shares.

Interest payments are in principle subject to a 30% withholding tax. Belgian tax law provides however – under certain conditions – for a withholding tax exemption for interest payments received by a professional investor being defined as a Belgian resident company, which should also be applicable to interest payments made to a REIT.

Dividends paid by a Belgian company to a REIT are in principle subject to a 30% withholding tax. Since the withholding tax treatment of domestic dividends has been aligned to the Parent-Subsidiary Directive as implemented in Belgian tax law, the REIT can benefit from a withholding tax exemption on the dividends received from a Belgian company, provided that the REIT has a participation of at least 10% in the share capital of the distributing company for an uninterrupted period of at least one year (or in case of commitment to keep such minimum participation during at least one year). Furthermore, an exemption of withholding tax is foreseen for dividends distributed by the REIT to a foreign investor to the extent such dividends include foreign source income. Also, non-Belgian pension funds benefit, under certain conditions, from a general exemption of dividend withholding tax, including on dividends distributed by a REIT.

Based on Article 4 of the OECD Model Tax Treaty, a REIT should be eligible for treaty protection as it can be considered to be resident for tax treaty purposes. A REIT is subject to corporate income tax in Belgium be it that the taxable basis is significantly reduced (notional tax basis). The taxable basis of a REIT does furthermore not include any exceeding net borrowing expenses in the sense of the 30% EBITDA interest limitation deduction rule.

The VAT status of a REIT depends on its outgoing supplied of services to its subsidiaries or to the tenants of the real estate assets.

The management of the REIT can benefit from a VAT exemption under certain conditions.

Accounting

The statutory accounts and the consolidated accounts (if any) of a public and an institutional REIT are to be drafted according to IFRS. A specific reporting scheme is provided for by the legislator.

Under IFRS, real estate investments have to be recorded in the books at fair market value. Fair value is the price a well-informed third party would pay for the real estate after deduction of the transfer taxes. The amount of these transfer taxes is dependent on the type of transfer, the buyer and the geographical location of the real property.

Real estate certificates

Real estate certificates may offer an advantage for small and medium-sized investors to tap into real estate income without the disadvantage of having to acquire and manage the underlying properties.

In the case of a public emission, the investments in real estate are made by specialised bodies, as required by the Financial Services and Markets Authority. The price of the investment is distributed among a certain number of certificates to be subscribed by interested investors (individuals or companies).

The certificates are transferable securities incorporating a debt. They can be bearer or registered and can be transferred without any specific formality. As a general rule, such certificates confer upon their owners the right to variable interest and a share of the potential capital gain resulting from the realisation of the real estate.

Although participating in a real estate investment, the certificate holder does not, from a legal viewpoint, have any title to the property funded; their right is assimilated to that of a creditor and not to that of a joint owner.

From an economic viewpoint, however, the certificate holder is in the same situation as the owner of a let property. The holder receives part of the rents in proportion to the holder's share in the investment. The holder bears all the risks of the investment (if the asset ceases to be rented, the certificate holder might not even recover the investment; if the asset is sold with a significant capital gain, this will be distributed in full to the certificate holders).

From a tax viewpoint, the main advantage of the instrument lies in the fact that, in spite of its hybrid character, income deriving from real estate certificates is considered, from a tax viewpoint, as interest (movable income).

In the hands of the issuing company, any distribution (in case of public emission) in excess of the refund of capital will consequently be tax-deductible, such as "normal debenture" interest charges would be. The predetermined depreciation of the debt vis-à-vis the certificate holders usually corresponds to the depreciation of the asset so that "interest" distributed to the holders will correspond to the income obtained from the asset less the operating expenses, ie, the company's taxable result before deduction of interest.

In the hands of certificate holders, any amount received in excess of the refund of the capital subscribed will be subject to Belgian WHT on interest. In most issues, provision is made for the full distribution of the operating balance to certificate holders. The issuing companies consequently should not bear any actual tax burden (taxable basis equal to zero after deduction of interest).

In particular, for investors for whom the WHT is a once-and-for-all tax on interest income, real estate certificates will appear to be advantageous. Apart from WHT (possibly waived or reduced by internal law or treaty provisions), the certificate holders should not bear any tax charge, even if the investment actually consists of real estate, and even if a significant capital gain is realised on the asset.

As a result of the conversion of the Interest-Royalties Directive into the Belgian internal law, interest paid or attributed by a Belgian company to a related EU company whose legal form is mentioned in the annex of the said Directive is exempt from the Belgian WHT of 30%. Two companies are related when:

- one company holds directly or indirectly a participation of more than 25% in the other company during an uninterrupted period of one year (or commits to do so).
- another EU company holds directly or indirectly a participation of more than 25% in both companies during an uninterrupted period of one year (or commits to do so).

This WHT exemption is also applicable for real estate certificates, except for the financial portion relating to the sale of the underlying building.

Please note that a private emission is equally possible. Nevertheless, in the hands of the issuing company, contrary to a public emission, any distribution in excess of the refund of capital will only be deductible if the "market interest rate" is respected. The deductibility of interest paid on the last coupon (ie, the distribution of the capital gain) can therefore be questioned.

Finally, note that a company issuing real estate certificate is explicitly excluded from the application of the aforementioned 30% EBITDA limitation rule.

Property taxes

Immovable withholding tax

For income tax purposes, a deemed rental income (*revenu cadastral*/*kadastraal inkomen*) is calculated for all real properties located in Belgium. This income is determined by estimating the "normal" net annual rental income of any property, or material or equipment that is regarded as immovable property. This deemed income is determined by the Land Survey Register (*cadastre*/*kadaster*). An appeal can be filed with the Register claiming reduction of the amount of this deemed rental income.

In principle, properties are reassessed every ten years. At present, however, this deemed income is still based on the annual rental value of the property on 1 January 1975. Limited indexation of the deemed income is nevertheless provided for every year.

Based on this deemed income, an immovable WHT is levied annually by way of assessment in the hands of the owner, usufructuary, or beneficiary of another real right. The immovable WHT on real estate assets amounts to 1.25% (2.5% in the Flemish Region) on the deemed rental income as indexed on 1 January of the tax year. Furthermore, provincial and municipal surtaxes can be levied on the (regional) immovable WHT. The basis for levying such surtaxes is the base immovable WHT and not the deemed rental income. The local surcharges increase the effective rate to 18%-50% or more (of the deemed rental income), depending on the municipality where the property is located.

Despite the name given to it in Belgium (*précompte immobilier*/*onroerende voorheffing*), Belgian immovable WHT is to be considered a once-and-for-all tax, as it will not be refunded and cannot be credited against corporate income tax. However, it is entirely deductible from the companies' taxable basis as a business expense.

It is to be noted that the immovable WHT is always assessed in the hands of the person who was the owner of the property, of the usufruct or of a right in rem on 1 January of the year in question. If the property is transferred after that date, the purchaser will not have to bear that charge for the first year, unless the transfer deed contractually provides otherwise.

Local taxes

General

Belgian legislation stipulates that municipalities, provinces, regions and communities may, under certain conditions, decide on the establishment, modification or abrogation of local taxes.

There are two main local real estate taxes, ie:

- surtaxes; and
- local taxes levied by the municipalities, provinces, regions and communities.

Surtaxes

Provinces, agglomerates and municipalities are in principle not authorised to levy surtaxes on income or similar taxes, except where they are expressly allowed to do so by a provision of federal law. Practically, they are allowed to levy surtaxes on Belgian personal income tax and on Belgian immovable WHT.

Surtaxes on personal income tax

The surtaxes on personal income tax are computed on the basis of the amount of personal income tax due. Please note that this surtax will normally have no impact for professional investment since most investments will be structured through a corporate structure and no surtaxes may be levied on corporate income tax.

Surtaxes on immovable WHT

See above "Property taxes".

Local taxes

Article 170 of the Belgian Constitution stipulates that Belgian communities, provinces, regions and communities are authorised to levy certain local taxes. The rate and the kind of these local taxes may vary, depending on the

municipality, province, region, or community levying said taxes. However, they may not be in breach of higher legal provisions.

The most current Belgian local taxes are as follows:

- local tax on offices;
- local tax on parking places;
- local tax on abandoned estates;
- local tax on second residence;
- local tax on advertisements;
- local tax on commercial land;
- local tax on construction works;
- local tax on waste and wastewater.

Conclusion

Structuring Belgian real estate investments

Obviously, there exists no single ideal scheme for carrying out every type of real estate investment in Belgium. The optimal structure will usually be determined in consideration of the following factors:

- the quality of the top investor (Belgian or foreign, individual or company, pension fund or corporate investor, etc);
- its objectives, ie, the purpose and term of the investment (construction and rapid sale, long-term management, etc);
- the characteristics of the project and the prospects concerning future returns and further investments.

At present, most large Belgian investments by groups specialised in the real estate business are structured in such a way that each separate project or investment is made using a special purpose company (one project – one company).

These companies in principle do not suffer a huge corporate tax burden on the regular income from the property, due to interest deduction on the leverage and NID on the equity. However, the 30% EBITDA interest limitation deduction rule (which entered into force as from assessment year 2020; see above) must be taken into account and may hence have an impact on the taxable basis of the company holding real estate.

Although it is basically oriented to the long-term management of the properties, this structure also offers great flexibility on sales, provided the potential purchasers agree to purchase the whole activity of a company. However, this structure is quite burdensome (numerous companies, each requiring separate legal forms and management).

An alternative for structuring large investments in Belgian properties is the single company structure. In this structure, all assets are managed within the same legal entity. The advantage of such a structure derives from its lower management costs and from the fact that, in cases of direct sales, the company can spread the tax on capital gains under the reinvestment condition. In this respect, the single company structure is useful if the objective is one of continuous growth and reinvestment. Nevertheless, this structure does lack flexibility (only direct sales of assets are feasible); a global sale of the company will be difficult and often result in direct sales of assets triggering corporate taxation. If the original investor wishes to divest itself of its properties progressively, it could contemplate transforming the company into a B-REIT or B-REIF.

When it is a single Belgian project that is being targeted, it is difficult to define the most efficient tax structure. When possible, the structure should at least be analysed from a VAT tax perspective (VAT sales of constructed buildings, constitution of rights in rem rather than mere leases, financial VAT leases, lease with optional VAT, etc) in order to ensure the VAT efficiency of the structure. Operating Belgian properties normally should not trigger substantial corporate tax charges, at least not until the sale of the asset, except when they are unusually profitable. However, the actual envisaged structures need to be defined beforehand, when the economic and financial characteristics and the destination of the asset are determined. Also, any of those should be tested against their financial and economic justification, especially in the light of the newly introduced general anti-abuse rule.

Finally, a recent alternative to structure real estate investments in Belgium for professional and institutional investors is the use of a REIF. The REIF has a flexible regulatory regime with a swift and light registration procedure. From a corporate tax point of view, the REIF is subject to an exit tax of 15% upon its registration (and any later acquisition of real estate) but will not be subject to tax on its real estate income and capital gains.

Dividends distributed by the REIF to its foreign investors are in principle subject to a 30% withholding tax but can benefit from certain exemptions (eg, for redistribution of foreign source income and for dividends distributed to pension funds) and withholding tax reductions (based on double tax treaties).

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Real Estate Going Global

Brazil

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

Acquisitions

Urban real property

Non-residents may invest in property through direct ownership from abroad, or through resident companies or partnerships.

The acquisition of real property by foreign individuals or companies observes the same procedures imposed on Brazilian citizens. Therefore, the acquisition must be formalised through a contract of purchase and sale as well as through a public deed.

Rural real property

According to Brazilian law, foreign individuals resident in Brazil and foreign companies may invest in rural properties, but there are several restrictions regarding the size of the area to be acquired and the interest to be held by the investors (ie, there might be a limitation to control acquisitions in rural real property by foreign investors). There are a few alternatives to invest via investment funds concerning this restriction of holding control.

Rural properties acquired by foreign companies must be destined for the implementation of agricultural, industrial or settlement projects and these activities must be related to the companies' purposes.

Rental income

Brazilian income tax is a federal tax levied on income and proceeds of any nature received by individuals or corporations. The taxable event is considered to be the acquisition of the right to dispose, economically or legally, of the following – either one of them or both:

- income, derived from capital, labour or a combination of both; and/or
- proceeds of any nature (not included in the above), which imply an increase in the individual's net equity.

According to Brazilian legislation, payment of income tax may be required from whoever is legally or economically entitled to dispose of it, including rental income.

Individual taxation

Individual taxation in Brazil varies according to the taxpayer's status (resident or non-resident). Resident taxpayers include Brazilian natural citizens, naturalised foreigners and others under specific conditions.

Brazilian resident taxpayers are taxed on their worldwide income, being subject to a progressive rate ranging from 0% to 27.5%.

Non-resident individuals are taxed as per the general rules for non-resident investors.

Corporate taxation

Brazilian tax legislation considers all legal entities, including branches, agencies or representatives associated with companies headquartered abroad, as subject to taxation.

Gains arising from real estate will be subject to income taxes, namely corporate income tax (*imposto sobre a renda das pessoas jurídicas*, or IRPJ), a federal tax levied at the 25% rate, and the social contribution on net income (*contribuição social sobre o lucro líquido*, or CSLL), a social contribution levied at the 9% rate.

Additionally, revenues of legal entities are subject to the Employees' Profit Participation Program (*programa de integração social*, or PIS) and the contribution for social security financing (*contribuição para o financiamento da seguridade social*, or COFINS) at the 1.65% and 7.6% rates, respectively, being allowed offsetting credits from certain inputs.

Depending on certain conditions, such as the total company revenues and the corporate tax regime elected, the PIS and COFINS rates can be reduced to 0.65% and 3% over gross proceeds (this will bring impacts on corporate income taxes, which will vary from 2.88% to 10.88% over gross proceeds). In this case, no deductions are allowed.

Non-residents

Non-resident taxpayers (both individuals and corporations) are subject to tax on their Brazilian-sourced income at the rate of 15% (the 25% rate applies for tax haven residents). Brazilian-sourced income is considered to be all income paid by Brazilian-sourced payers, regardless of the nature, or which period it relates to.

Capital gains on the sale of property

Individuals

Capital gains arising from the disposal of real estate property by Brazilian individuals are currently taxed at the 15% rate. As from 2017, gains are subject to income tax at a progressive rate ranging from 15% to 22.5%, based on the total amount of capital gains received.

Capital gains earned by a resident individual on the sale of residential real estate is exempt of such tax, provided the seller, within 180 days from the sale, uses the earnings to buy a new house in the country. This rule is only applicable for determined individuals after a gap of five years between the transactions.

Corporations

Capital gains arising from the sale or exchange of fixed assets are treated as ordinary income and taxed at the regular rates (ie, IRPJ and CSLL rate 34%) plus PIS/COFINS at the combined 9.25% rate (3.65% if the taxpayer is under the cumulative method) if the real estate is a non-fixed asset.

Real estate developers may apply for a special taxation regime (*regime especial tributário*, or RET). Under this regime, the taxes IRPJ, CSLL, PIS and COFINS are paid at the unified tax rate of 4% of the received revenues. The tax rate may be reduced to 1% if the real estate development has social purposes.

Non-residents

Disposal of real estate properties by non-resident individuals is subject to withholding tax (IRRF, the Brazilian term for withholding income tax, or WHT) at the rate of 15%. As from 2017, gains recognised by Brazilian non-resident investors on the sale of real estate property are subject to a rate ranging from 15% to 22.5%, based on the amount of capital gains received. If the disposal is made by a beneficiary domiciled in a tax haven country/territory, capital gains are subject to 25% WHT.

Capital gains realised by non-residents are generally determined as being the difference between the sales price and the cost basis of the asset or right sold.

Real estate transfer tax (ITBI)

Transference of real estate property and/or related rights are usually subject to the real estate transfer tax (*imposto sobre transmissão intervivos de bens imóveis*, or ITBI), based on the value of the sale or transfer. Each municipality imposes its own ITBI rates, usually ranging from 2% to 4%. Certain transferences (eg, capital contribution with real estate assets) may be tax-exempt, provided certain conditions are met.

Other relevant taxes – IPTU, ITR and ITCMD

A municipal real estate tax, (*imposto sobre a propriedade predial e territorial urbana*, or IPTU) is imposed on the holding of real estate. The tax is calculated on an appraised value of the property (not necessarily the fair market value), which is estimated by the Federal Government and shall reflect the property value in case of sale. The rates vary from one municipality to another, on average from 0.3% to 2.8% per year, limited to 15% per year.

The same rules, pertinent to the taxable basis, taxable event and the taxpayer, also apply to the federal tax (*imposto sobre a propriedade territorial rural*, or ITR) which is levied on the ownership or possession of rural property. The tax rate ranging from 0.03% to 20% is determined considering the size of the area and how much the area is used.

The state tax (*imposto sobre a transmissão "causa mortis" e doação de bens e direitos*, or ITCMD) is levied on inheritances and donations of real estate properties and their rights. The rates vary from state to state; usually from 2% to 4% (maximum rate is 8%).

Other real estate investment structures

Other alternatives for investing into real estate assets or real estate companies are also available for both, local and non-resident investors.

Certain alternatives, such as investing in real estate funds (*fundo de investimento imobiliário*, or FII) or private equity funds (*fundo de investimento em participações*, or FIP) may provide a more tax-efficient scenario, especially for non-resident investors. For instance, gains arising from the disposal of FIP quotas, provided certain conditions are met, may be tax-exempt. A case-by-case analysis should be carried out to verify the most tax-efficient scenario.

Real Estate Investments

Preface

Historically, the property market in Brazil was considered less a financial asset and more as a physical asset that could better protect investors from economic instability, inflation and occasional political uncertainty. However, it is well-known that this concept of investment in real estate in Brazil has undergone a significant change.

Despite macroeconomic and political crisis, regarding foreign investors, who may be subject to certain tax benefits, Brazil is still in competitive position relative to other emerging markets in the realty sector. Mainly because of the valuation of the US dollar in comparison to local currency and necessity of the Brazilian local players for liquidity.

Investment in Brazilian property

Corporate and individual investors (mainly foreign investors, who could apply for certain tax benefits) have various options to better structure their investments in Brazil. The choice of the best alternative for structuring investments in the property sector will depend on the characteristics of the investment to be proceeded.

In the following sections, we describe different possibilities for investing in real estate in Brazil:

(i) direct acquisition, ie, the direct acquisition by the future owner of the real estate; and

(ii) indirect acquisition (ie, through a vehicle – an entity or an investment fund).

Direct acquisition for residents

Individuals

As a general rule, Brazilian resident taxpayers are taxed on their worldwide income on a progressive tax rate. Tax rates based on the monthly income are set out in the table* below (using an exchange rate of 5 Brazilian *real* (BRL) to 1 USD).

Taxable basis (in USD)	Tax rate (in %)	Deductible amount (in USD)
Up to 380.80	Exempt	0
From 380.81 to 565.33	7.5	29
From 565.34 to 750.21	15	71
From 750.22 to 932.94	22.5	127
More than 932.94	27.5	174

*This table is valid for 2020.

Resident taxpayers must file an annual income tax return (on or before 30th April of each year) to determine the actual amount of tax to be paid for the previous calendar year. The annual return includes a list of assets and liabilities that a taxpayer must report. This list must describe the relevant items of the taxpayer's net equity owned in Brazil and abroad (such as properties, vehicles, checking and savings accounts) and their respective values/balances at the end of the subject calendar year as well as for the previous one.

In addition, resident taxpayers are required to inform the Brazilian Central Bank (BACEN) about their assets and rights held outside Brazil, in case the total exceeds 100,000 USD.

Capital gains accrued by individuals on the disposal of real estate property are subject to the 15% rate. As from 2020, gains are subject to income tax at a progressive rate ranging from 15% to 22.5% based on the total amount of capital gains received as set out in the table* below (using an exchange rate of 5 BRL to 1 USD):

Taxable basis (in USD)	Tax rate (in %)
Up to 1,000,000	15
From 1,000,000 to 2,000,000	17.5

From 2,000,000 to 6,000,000	20
More than 6,000,000	22.5

*This table is valid for 2020.

The gain is determined as the difference between the sales price and the acquisition cost, duly reported in the seller's annual income tax return.

From 2005, capital gains are exempt from income tax on the sale of goods and rights, when the sales price does not exceed (using an exchange rate of 5 BRL to 1 USD):

(i) 4,000 USD (equivalent to 20,000 BRL) for shares sold through the over-the-counter market; and

(ii) 7,000 USD (equivalent to 35,000 BRL) in all other cases.

Also, the capital gains earned by resident individuals on the sale of residential real estate are exempt of such tax, if the seller, within 180 days from the sale, uses the earnings to buy a new house in the country. This rule is only applicable for a determined individual after a gap of five years between the transactions.

Gains derived from sales of real estate acquired by the seller before 1970 are also tax-exempt for Brazilian residents. Proceeds from the sales of real estate acquired by the seller between 1970 and 1988 have a progressive reduction on the capital gains levied on them. Since October 2005, there has also been a reduction factor applicable to the calculation basis of the capital gains on the sale of residential real estate by resident individuals

Corporations

Income arising from real estate properties will be subject to corporate (IRPJ/CSLL) and transactional taxes (PIS/COFINS).

Both, rental income and capital gains on the disposal of real estate property, will be subject to income tax (IRPJ) and social contribution on net profits (CSLL) or "corporate taxes", which can be paid on a real profit basis or on a presumed profit basis.

IRPJ and CSLL can be paid on an annual basis, through monthly prepayments, or on a quarterly basis.

The real profit basis is obtained through net accounting profit adjusted by certain additions and exclusions, and subject to the rate of 15% with a surcharge of 10% on the annual taxable income exceeding around 48,000 USD (using an exchange rate of 5 BRL to 1 USD). CSLL is a federal contribution levied on a similar basis, at the rate of 9%.

In this case, the costs or expenses incurred (eg, on the improvement of the real state) can be deductible from the net accounting profit (either at the sale of the units if the costs incurred were incorporated at the asset value or if accrued directly to P&L) and, as a consequence, from the calculation basis of IRPJ and CSLL.

The presumed profit may be elected for companies with gross income lower than 15.6 million USD (using an exchange rate of 5 BRL to 1 USD) per year. The presumed profit method (PPM) involves the application of a presumed rate on top of gross revenues depending on the activity of the company (eg, 32% for services and 8% for sales) for the purpose of calculating a presumed net income on which the above referred IRPJ/CSLL rates will be applicable.

Other revenues, such as financial revenues, will be subject to the rate of 15% with a surcharge of 10% of IRPJ plus CSLL at the 9% rate.

Basically, the choice between the actual profit method (APM) and the PPM will depend on the Brazilian entity's profit expectations.

Operating losses may be carried forward indefinitely for both income tax and social contribution purposes and may be offset up to an amount of 30% of each year's taxable income. Loss carryforward attributable to capital losses may only be offset against future capital gains.

Depreciation rates are generally determined by the tax authorities, who normally adopt the rate of 4% per year for real estate depreciation purposes.

Law 11638/2007 established new criteria for evaluation of fixed assets. For accounting purposes, the recommendation is that depreciation shall be based on the lifetime of the asset and on the residual value of the asset. It should also periodically be "reviewed and adjusted to the criteria used to determine the estimated economic life" (impairment) for the purpose of calculation of depreciation, at least periodically.

As of the effectiveness of the Law 12973/2014 for tax purposes, the gains resulting from fair market value adjustments shall not be considered into tax computation if certain accounting rules are met.

In addition to IRPJ/CSLL, revenues earned with real estate (either sale or rental) may be subject to the Employees' Profit Participation Program (PIS) and Social Contribution on Billings (COFINS). Depending on the tax base calculation regime (APM or PPM), the calculation of PIS and COFINS will also change.

If the entity is subject to the real profit basis, the company is automatically subject to the payment of PIS and COFINS according to the non-cumulative system.

Under the non-cumulative method, a combined rate of 9.25% is applied on top of gross revenues (understood as all revenues arisen from companies' corporate purpose) and it is possible to offset certain credits.

If a Brazilian entity decides to apply for the PPM, all revenues will be submitted to PIS and COFINS cumulative system, ie, all the revenues will be taxed without the possibility of deduction of credit; however, the rates will be lower (ie, 0.65% plus 3%). It has to be highlighted that the financial revenues might be levied under the cumulative system, if included in the concept of gross revenue of the company.

Disposal of real estate under both methods, the non-cumulative and cumulative, may not be subject to PIS and COFINS taxation depending on the corporate purpose of the company as well as of accounting criteria of the real estate asset.

Real estate developers may apply for a special taxation regime (*regime especial tributário*, or RET). Under this regime, the taxes IRPJ, CSLL, PIS and COFINS are paid at the unified tax rate of 4% of the received revenues. The tax rate may be reduced to 1% if the real estate development has social purposes.

Non-residents

Rental revenues accrued by non-resident taxpayers are subject to tax on their Brazilian-sourced income at a rate ranging from 15% to 25% depending on the location of the beneficiary. Brazilian-sourced income is considered to be all income paid by Brazilian-sourced payers, regardless of the nature, or which period it relates to.

Disposal of real estate properties by non-resident individuals is subject to WHT at the rate of 15%. As from 2017, gains recognised by Brazilian non-resident investors on the sale of real estate property are subject to a tax rate ranging from 15% to 22.5%, based on the amount of capital gains received. If the disposal is made by a beneficiary domiciled in a tax haven country/territory, capital gains are subject to 25% WHT.

Capital gains realised by non-residents are generally determined as being the difference between the sale price and the cost basis of the asset or right sold.

Tax on financial operations (IOF)

As of January 2008, the Brazilian social contribution due on cash flows (CPMF) rule was revoked. In the place of CPMF, certain transactions, mainly related to loans or to exchanging amounts can trigger the tax on financial operations (IOF).

Inflow and outflow of resources related to foreign direct investments (eg, a direct acquisition of real estate or incorporation of a Brazilian company) is subject to IOF at the rate of 0.38%.

Foreigner investors, whenever investing through Resolution CMN 4373, for variable and fixed income assets traded in financial and capital markets (eg, real estate investment funds), will be taxed by IOF at 0% on the inflows and outflow of resources in the country.

Real estate transfer tax (ITBI)

The sale/transference of real estate by individuals, corporations and non-residents is subject to the real estate transfer tax (*imposto sobre transmissão de bens imóveis intervivos*, or ITBI), a tax on the transfer of real estate and related rights, which is imposed by the municipality, based on the value of the sale or transfer.

The taxable events for the ITBI are as follows:

- any sales or transfers of real estate, including any objects attached thereto;
- any transfer of ownership rights to real estate, except for guaranty rights; and
- any assignment of rights in connection with the aforementioned transfers.

This tax is not payable when the transfer of the property or rights is made with the intention that the property or rights be incorporated as part of a company's assets as payment for subscribed capital or in a spin-off or merger. However, if the company carries real estate activities, such as sale or lease of real estate, the transaction shall be subject to the related tax.

The tax is calculated upon the market value, understood as the transaction price of the property or rights as of the date of the transfer or assignment.

Each municipality imposes its own ITBI rates, and there are no federal or state limitations imposed on them. Typically, ITBI rates varies from 2% to 4%.

Other relevant taxes – IPTU, ITR and ITCMD

A municipal real estate tax (*imposto sobre a propriedade predial e territorial urbana*, or IPTU) is imposed on the holding of real estate (including the buildings or structures thereon, but not including the moveable property within them). The IPTU taxable event is the ownership, dominium, or possession of the real estate. The IPTU taxpayer is the owner of the property, or the one that has possession or dominium. The tax is calculated on an appraised value of the property (not necessarily the fair market value), which is estimated by the Federal Government and shall reflect the property value in case of sale. As IPTU is a municipal tax, the rates vary from one municipality to another, on average from 0.3% to 2.8%, depending on the type of the real estate (ie, residential or non-residential, rural or urban land) and limited to 15% per year.

The same rules, pertinent to the taxable basis, taxable event and the taxpayer, also apply to the federal tax (*imposto sobre a propriedade territorial rural*, or ITR) which is levied on the ownership or possession of rural property. The tax rate ranging from 0.03% to 20% is determined considering the size of the area and how much the area is used. An annual return must be filed for ITR purposes describing the details of each rural property.

The state tax (*imposto sobre a transmissão "causa mortis" e doação de bens e direitos*, or ITCMD) is levied on inheritances and donations of real estate properties and their rights. The rates vary from state to state; usually from 2% to 4% (maximum rate is 8%).

Indirect acquisition through a Brazilian entity

Corporate taxes for a Brazilian entity

One alternative for structuring a real estate investment is incorporating a Brazilian entity. Taxation for Brazilian entities comprises corporate taxes (IRPJ/CSLL) and transactional taxes (PIS/COFINS). For further details on the taxation of Brazilian entities, please refer to the subsection "*Corporations*" below.

Remittance of profits by a Brazilian entity

The profits from a Brazilian company carrying real estate activity (selling or rental) can be remitted as dividends or interest on net equity (INE).

The dividend will not be subject to WHT nor IOF.

The payment of INE will be subject to WHT at the 15% rate and 0% IOF. If the Brazilian entity adopts the real profit basis, it will be allowed to deduct the expense relating to INE from its IRPJ and CSLL, if paid up to the limits established by law.

As from 2010, Brazil started to impose thin capitalisation rules in relation to the loans between affiliated entities and specifically more conservative rules applicable for loans with parties located in a tax haven jurisdiction. Also, transfer pricing rules should be observed in related party transactions, limiting deductibility of interests paid to related parties.

Capital gains on disposal of shares in a Brazilian entity

Individuals

Gains arising from the disposal shares are currently taxed at the 15% rate. As of 2017, gains recognised by Brazilian individuals on the sale of real estate property are subject to rates ranging from 15% to 22.5%, based on the amount of capital gain received. Also, the capital gain earned by a resident individual on the sale of residential real estate is exempt of such tax, if the seller, within 180 days from the sale, uses the earnings to buy a new house in the country. This rule is only applicable for determined individuals after a gap of five years between the transactions.

Corporations

Corporate capital gains arising from the sale or shares are treated as ordinary income and taxed at the regular rates (please see also section "*Corporate taxes for a Brazilian entity*"). PIS/COFINS may apply on the disposal of shares by holding companies.

Non-residents

Disposal of shares of a Brazilian entity by non-resident investors are subject to withholding tax at the rate of 15%. As of 2017, gains recognised by Brazilian non-resident investors on the sale of real estate property are subject to rates ranging from 15% to 22,5%, based on the amount of capital gain received.

If the disposal is made by a beneficiary domiciled in a tax haven country/territory, capital gains will be subject to 25% withholding tax. For Brazilian tax purposes, a tax haven is considered to be a country that taxes income at a rate lower than 20%.

Capital gain realised by non-residents is generally determined as being the difference between the sale price and the cost basis of the asset or right sold, which must be substantiated by the corresponding document usually issued when the acquisition takes place. If the cost cannot be substantiated in this manner, the acquisition amount will be determined, in some instances, based on the capital amount registered with the Brazilian Central Bank related to the purchase of the asset or right. In all other instances, the cost will be deemed to be zero.

At last, Brazilian legislation is not clear on the method of calculating capital gains in Brazilian currency or foreign currency registered with the Brazilian Central Bank (BACEN).

The outflow for remitting capital gains derived from investments generated through Law 4131 (private participation into a Brazilian entity) will trigger IOF at 0.38% of the amount remitted.

Indirect acquisition through a Brazilian investment fund

Depending on the structure to be adopted, foreign investor may find more tax-efficient if investing via: (i) real estate investment fund or FII (whose portfolios encompass real estate); (ii) private equity investment fund or FIP (whose portfolios encompass interest in entities that can own properties); and (iii) receivables investment fund or FIDC (whose portfolios can encompass real estate receivables).

Foreigner investors, whenever investing through Resolution CMN 4373, for variable and fixed income assets traded in financial and capital markets (eg, real estate investment funds), will be taxed by IOF at 0% on the inflows and outflow of resources in the country.

Corporate and transactional taxes for an investment fund

As a general rule, quota holders are subject to WHT on profit distribution, quota redemption or quota sales. If the quota holder redeems the investment prior to 30 days of the acquisition, tax on financial transactions (IOF) will be due.

Investment fund portfolios are not subject to any kind of tax.

Remuneration of quotas of investment funds

A taxable event for the owner of a participation in an investment fund is remuneration of the quotas. The tax treatment applicable will vary in accordance with the characteristics of the investor, as described below.

Individuals

Remuneration of quotas depends on the nature of the fund ranging from 15% to 22.5%. Remuneration by FII's may be tax-exempt, provided certain conditions are met. Capital gains are typically subject to 15%. WHT cannot be offset with the individual income tax (*imposto de renda da pessoa física*, or IRPF) due by the quota holder.

Corporations

Gains arisen from investment funds or disposal of fund quotas will be subject to corporate taxation (see section "*Corporate taxes for a Brazilian entity*".

Non-residents

Non-residents holding investment funds, may be subject to a more beneficial taxation is comparison with resident investors, provided the investment is carried in accordance with Resolution 4373, and if it is not resident or domiciled in a tax haven jurisdiction. Tax haven investors are subject to the same rules applicable to Brazilian residents.

As per example, remuneration of FIP is tax-exempt if the rules regarding concentration are accomplished and provided the investment is in accordance with Resolution 4373 and the investor is not located in a tax haven jurisdiction. FIDC and FII distributions are typically subject to 15% WHT on distributions to foreign investors non-domiciled in tax haven jurisdictions.

Capital gains of non-tax haven investors on the sale of fund quotas in the stock exchange is not subject to WHT. Regulatory restrictions may apply to listing on a few types of funds.

The operation of inflows of amounts for acquiring quotas will be taxed by IOF at 0%.

Brazilian tax reform

On 21 July, the Brazilian Government presented its plan for a Brazilian tax reform. The first phase of the Government project proposes that the federal contributions (referred to as PIS/COFINS) will be replaced by a contribution on goods and services (simplified as “CBS” for its Portuguese acronym), which would function as a federal value-added tax (VAT). The Government’s proposal is coherent with the broader Constitutional Amendment Projects (PEC) being discussed in Congress for creation of a single goods and services tax (GST), which in addition to PIS/COFINS, would also seek to unify the state ICMS tax (a quasi-VAT) and municipal ISS tax (a cumulative tax on certain service charges).

CBS’ taxpayers and responsible parties:

(i) legal entities (and equivalent under corporate tax law); and

(ii) importers of goods as well as the contractor, the recipient or the acquirer in relation to the importation of services and intangibles.

As for CBS base:

(i) gross revenue earned in each sale of goods and services included in the principal operating activities of the legal entity, minus: (a) the taxes levied on the transaction or base (the proposed law cites ICMS and ISS, but is not explicit in regard to other levies); (b) unconditional discounts; and (c) the CBS itself, eliminating the controversial “gross-up cascading effect” historically embedded in Brazil’s transactional taxes; or

(ii) the customs value of the imported goods, including intangibles, and the value before withholding taxes in relation to the import of services (covering the assignment and licensing of rights). The calculation basis does not include revenues from the exportation of goods and services abroad.

The CBS rate would be 12% in general, with certain exceptions (eg, financial sector, agriculture). Financial and related institutions would be taxed at the rate of 5.8% of monthly gross revenue without the right to recover input tax credits or to be recovered by B2B customers. This is a controversial aspect of the proposed law.

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Real Estate Going Global

Bulgaria

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Real Estate Tax Summary

General

There are no legal restrictions upon foreign legal entities and individuals acquiring ownership and other property rights over buildings (or parts thereof) in Bulgaria; they are also allowed to hold limited property rights (such as the right to build, right to use, etc) over land plots.

Citizens of EU Member States and EEA States as well as legal entities from these States are allowed to acquire and hold title to land, including agricultural land, in Bulgaria.

Individuals and legal entities from third countries (non-EU/-EEA States) can acquire title to land, if provided under an international treaty, which is ratified by the Bulgarian Parliament, published in the Bulgarian State Gazette and entered into force. Further limitations exist with respect to agricultural land. The following persons cannot acquire title to agricultural land:

- individuals and legal entities from third countries (unless in accordance with an international treaty, as mentioned above) and Bulgarian companies, in which such persons are shareholders;
- individuals and legal entities that have resided in, or have been domiciled in, Bulgaria for less than five years; and
- newly incorporated Bulgarian legal entities, which have existed for less than five years, unless the shareholders/founders of such entities are persons who have resided in, or have been domiciled in, Bulgaria longer than five years.

Individuals and legal entities from tax heaven jurisdictions (as per an officially approved list), as well as companies controlled by such persons, cannot acquire agricultural and forest land.

Rental income

Rental income is subject to general corporate income tax of 10%. The rental income of foreign individuals or legal entities resulting from renting out immovable property located in Bulgaria, is generally subject to 10% withholding tax (WHT) in Bulgaria unless exempt or reduced under an applicable double tax treaty (DTT).

Interest expenses

Business-related interest expenses are generally tax-deductible, subject to potential restrictions under the tax thin capitalisation regime and the interest limitation regime, outlined below. Companies applying IFRS determine the interest expenses eligible for capitalisation into the value of the property based on the relevant accounting standards.

Interest expenses may not be fully tax deductible in the year when accounted for, if restricted under the thin capitalisation regime. The regime applies if the debt-to-equity ratio (D/E) of the company exceeds 3:1 for the respective year (calculated based on average values as at 1 January and 31 December). If the thin capitalisation regime is triggered, regulated interest expenses are tax deductible only up to a certain percentage of the company's earnings before interest and taxes (EBIT).

Interest under bank loans/financial leases is generally not regulated under the thin capitalisation regime, unless the transaction is between related parties or the bank loan/lease is guaranteed by a related party or extended at their request, etc. Interest and other loan-related expenses capitalised in the value of an asset in accordance with the applicable accounting standards, as well as interest expenses not recognised for tax purposes on other grounds, would be outside the scope of the thin capitalisation restrictions. Restricted interest expense in a given year, may be utilised (deducted for tax purposes) in subsequent years if there are sufficient profits (no time limitation applies).

As of January 2019, in parallel to the existing thin capitalisation regime, new interest limitation rules are introduced to the Corporate Income Tax Act, transposing the so-called ATAD (Anti-Tax Avoidance Directive) of the EU[1]. Under the new interest limitation regime, net borrowing costs are tax deductible in the year when incurred, only up to 30% of the company's tax adjusted earnings before interest, taxes, depreciation and amortisation (EBITDA). If the net borrowing costs for the year are up to 3 million EUR, the interest limitation regime does not apply (but the

[1] Council Directive (EU) 2016/1164 of 12 July 2016

thin capitalisation regime may still apply). Any resulting non-deductible borrowing costs can be carried forward and deducted in future years without a time limitation based on a special formula.

Depreciation

Under Bulgarian legislation, accounting depreciation charges are ignored for CIT purposes. Instead, tax depreciation within the maximum annual tax depreciation rates prescribed per specific categories of assets under the CIT legislation, is tax-deductible. The maximum tax depreciation rate for buildings is 4% yearly. The tax depreciation is computed on the basis of tax depreciation plans, which have to be prepared separately from accounting depreciation plans.

Land is not tax depreciable.

Real Estate Investments

Introduction

The real estate market in Bulgaria ranked among the main foreign direct investment (FDI) and gross domestic product (GDP) drivers prior to the 2007-2008 financial crisis attracting large investments in the country. The economic downturn resulted in falling prices, cease of projects, decrease in investment activity and rise of non-performing loans related to property financing.

Over the last four years, the sector is once again becoming more attractive to investors in line with economy recovery and the positioning of the country as a preferred outsourcing destination for IT, BPO, automotive and industrial companies. The market offers potential for rental level growth, demand for quality developments, restructuring opportunities for non-performing property related loans and attractive yields. The effects of the COVID-19 pandemic are not clear yet.

Legal aspects

In the course of the pre-accession negotiations with the EU, Bulgaria undertook the commitment to adopt and implement in its legislative system the basic principle of *acquis communautaire* for free movement of capitals. The process of implementing the European policy of free movement of capital started in 2005, prior to the accession of Bulgaria to the EU, when the Bulgarian Parliament amended the Constitution abolishing the general prohibition for foreign individuals and legal entities to hold ownership over land in Bulgaria. The amendment became effective on 1 January 2007, when the Treaty for Accession of the Republic of Bulgaria to the European Union (hereinafter referred to as the "Treaty"), entered into force.

Now, the Bulgarian Constitution embeds the imperative rule that non-Bulgarian citizens and legal entities may acquire ownership over land under the terms arising from the Treaty or by virtue of an international treaty, which has been ratified and promulgated, and which has entered into force for the Republic of Bulgaria.

Being an organic law that sets only the legal framework, the Constitution stipulates that the regime applicable to acquisition of different types of land has to be established and further detailed by a statute that follows the Constitution.

After joining the EU, Bulgaria kept the ban for acquisition of agricultural land, forests and forestry land by nationals and legal persons from the EU Member States and EEA States for a period of seven years. Though the ban was no longer effective as from 1 January 2014, the legislation related to acquisition of agricultural land was amended in May 2014.

The following persons cannot acquire title to agricultural land:

- individuals and legal entities from third countries, non-EU Member States or EEA States (unless in accordance with an international treaty, as mentioned above) and Bulgarian companies, in which such persons are shareholders;
- individuals and legal entities that have resided in, or have been domiciled in, Bulgaria for less than five years; and
- newly incorporated Bulgarian legal entities, which have existed for less than five years, unless the shareholders/founders of such entities are persons who have resided in, or have been domiciled in, Bulgaria longer than five years.

Individuals and legal entities from tax heaven jurisdictions (as per an officially approved list), as well as companies controlled by such persons, cannot acquire agricultural and forest land.

Ownership of real estate can be acquired through a transfer contract, based on a contribution in-kind into a company, or on other bases stipulated by law (eg, inheritance).

Contracts transferring ownership over a real estate or establishing limited property rights over real estates (such as right to construct, right to use, etc) are in principle executed in the form of notary deeds. Afterwards, the title transfer should be registered with the Real Estate Register kept with the respective registry office as per the location of the real estate.

Taxation aspects

When investing in real estate in Bulgaria, the following points should be considered:

- Corporate income tax applies at the flat 10% rate.
- Special purpose investment companies under the Special Purpose Investment Companies Act (SPIC Act), are exempt from corporate income tax. These legal entities are established under the conditions of the SPIC Act as joint stock companies, which may invest only in real estate or in receivables and are obliged by law to distribute not less than 90% of the realised profit to their shareholders.
- Tax losses can be carried forward over the following five consecutive years.
- Group taxation is not allowed in Bulgaria.
- WHT at 10% applies to certain Bulgarian-source income of non-residents, eg, interest, royalties, technical services (including consulting, management and assembly and installation) fees, rental payments and capital gains. Dividends and liquidation quota distributed to individual and non-resident shareholders are generally subject to 5% Bulgarian WHT. Exemption applies if distributed to EU/EEA resident companies.
- Interest and royalty accrued to eligible associate companies established in the EU are not subject to WHT under the EU Interest and Royalty exemption regime as implemented in the domestic legislation (broadly requiring 25% shareholding for at least two years).
- Foreign exchange fluctuations are recognised for corporate income tax purposes.
- The headline real estate annual tax rate is between 0.01% and 0.45%, determined by each municipality as per the property location. Likewise, the transfer tax may vary from 0.1% to 3%. Donation tax varies between 3.3% and 6.6% depending on the municipality where the donated real estate is located.
- Additional to the transfer tax when transferring a real estate in Bulgaria registration fee (amounting to 0.1% of the higher between “the tax value” and the price agreed in the notary deed) and notary fee (under a scale up to 6,000 Bulgarian Lev, or BGN) is due.
- No stamp/capital duty is levied in Bulgaria.

Corporate tax

Legal entities established under Bulgarian law are taxed on their worldwide income.

The taxable profit represents the financial result of the company adjusted for tax purposes with certain finance-to-tax adjustments. Generally, tax depreciation of buildings (within the prescribed caps as described above), repairs and maintenance are deductible for tax purposes. Impairment and revaluation of assets are not recognised for tax purposes in the year when accounted for – they form a temporary tax difference, subject to reversal in subsequent periods under the applicable conditions.

Bulgarian tax law requires that transactions between related parties be carried out at market-based terms/prices. If the price of a transaction differs from the price that would be agreed between independent persons, the tax authorities may challenge the contracted price and adjust the tax base to relevant market levels.

Value-added tax (VAT)

The standard VAT rate in Bulgaria is currently 20%. There is a reduced rate of 9%, which applies for accommodation in hotels and other similar places, as well as (temporarily until the end of 2021) – for restaurant and catering services, and certain books and baby products.

The VAT Act provides for mandatory VAT registration (eg, upon reaching a taxable turnover of 50,000 BGN for a period not longer than two consecutive months, including the current month, or for a period of 12 months, or when performing intra-community acquisitions, or in case of supply/receipt of services subject to reverse charge, etc), and separately – for the possibility of voluntary VAT registration. The Bulgarian legislation does not provide for retroactive VAT registration. Foreign resident companies not established in an EU Member State may be registered for VAT purposes in Bulgaria only through a fiscal representative, except if the company has a branch in Bulgaria. For the purposes of the mandatory VAT registration, the Bulgarian revenue authorities could register a foreign company, which is required to appoint a fiscal representative, even if it has failed to do so.

The transfer of ownership over land and the renting out of land is generally VAT-exempt. However, the transfer of regulated land plots in Bulgaria (ie, land that is eligible to be built upon) is a supply subject to 20% VAT.

The disposal of buildings not qualifying as “new” (and the underlying area plus an adjacent area with three metre width), eg, for which the stage of “rough construction” has not been completed, or for which more than five years

have passed from the date of issuance of the permit for their use, is VAT-exempt. The sale of “new” buildings (and the underlying area plus an adjacent area with three metre width) or units in them is always subject to VAT.

The rent of buildings is a VAT-able supply, except when rented out to individuals for residential purposes.

Where the above supplies are VAT-exempt, there is an option for the supplier to treat them as subject to VAT.

The sale of construction rights over land is VAT-exempt until the issuance of construction permit.

If a company uses a building partly for the provision of taxable supplies, and partly for provision of exempt supplies/performance of non-taxable activity, it would be entitled to partly (pro rata) recover the input VAT incurred on the purchase/rent of the building. A change of the use of the building from taxable to exempt activities over a period of 20 years may have an impact on the right of input VAT credit, which is to be adjusted, based on a specific formula.

Real estate related services (such as those performed by consultants, architects, engineers, supervisors, intermediary brokers, etc) are generally considered with place of supply in Bulgaria and attract Bulgarian VAT when the real estate is located in the country. In case the supplier is a taxable person not established in Bulgaria, the Bulgarian VAT should be charged by the recipient of the above services (a taxable person) in Bulgaria under the reverse charge mechanism.

VAT reporting is done on a monthly basis. The general period for VAT recovery is three months after the submission of the relevant VAT return. A foreign company may recover VAT incurred for real estate-related services in Bulgaria under certain conditions.

Real estate tax

An annual real estate tax is levied on land and buildings. The tax rate is determined between 0.01% and 0.45% by each municipality as per the property location. The tax is calculated on the tax value of the respective property. When a real estate represents an asset of a legal entity, the real estate tax is levied on the higher between the tax value and the gross book value of the real estate as per the balance sheet of the company. The tax is generally due from the owner of the real estate. Two instalments are made: until 30 June, and until 31 October of the current year. The tax can be paid in one instalment until 30 April with a 5% discount.

Withholding tax

Dividends distributed by a Bulgarian entity to an individual or non-resident shareholder are generally subject to a 5% WHT in Bulgaria. The rate may be reduced under an applicable double tax treaty (DTT). The dividend distribution made by a local company in favour of a company, tax resident of an EU/EEA country are exempt from WHT, except for cases of hidden profit distribution.

Dividends distributed by a Bulgarian entity to local trading companies are not taxable. An exception is envisaged, and the dividend income is taxable where the distributing entity is a special purpose investment company or in cases of hidden profit distribution.

Interest accrued to non-resident lenders is generally subject to Bulgarian WHT at the rate of 10%. The rate may be reduced in accordance with the relevant DTT.

Under the Interest and Royalty rules as implemented in the local legislation, interest income accrued to eligible EU-tax resident entities accrued by a Bulgarian related party company, are exempt from Bulgarian WHT under certain conditions (eg, minimum shareholding of 25% for at least two years, etc).

Real estate acquisition

Legal aspects

Methods of acquisition

Subject to the above stated limitations, investors may:

(i) directly acquire real estates;

(ii) establish a Bulgarian legal entity that will acquire the real estate; or

(iii) acquire shares in a Bulgarian company that owns the real estate.

It is advisable to conduct a thorough due diligence review of the targeted asset before the acquisition. When reviewing a company, the due diligence review shall cover its legal and tax position.

Choice of entity

Under the Bulgarian Commerce Act, the following Bulgarian legal entities may be established:

- general partnership (*sabiratelno drujestvo*).
- limited partnership (*komanditno drujestvo*).
- partnership limited by shares (*komanditno drujestvo s aktsii*).
- limited liability company (*drujestvo s ogranichena otgovornost*).
- joint stock company (*aktsionerno drujestvo*).

All these types of entities may own real estate, even if they are fully owned by foreign entities, or foreign individuals (except for the restriction related to the agricultural land as already mentioned above).

The limited liability company and the joint stock company are the most frequently used types of companies in Bulgaria. A limited liability company may be founded by one or more resident or non-resident persons, who may be either legal entities, or individuals. The minimum registered capital required for new limited liability companies is 2 BGN.

A joint stock company can be founded by one or more resident or non-resident persons, who may be either legal entities or individuals. A joint stock company requires a minimum share capital of 50,000 BGN.

Tax aspects

Capital gains and losses on the sale of property or shares

Capital gains realised on the sale of property are included in the corporate income tax base of the company and taxed at the regular corporate income tax rate of 10%. Capital losses from the sale of real estate are generally deductible for corporate income tax purposes.

Capital gains derived from the sale of shares in a Bulgarian company by a foreign shareholder are subject to Bulgarian WHT of 10%, unless the share transfer is executed on a regulated market in the EU/EEA. The tax liability may be reduced under an applicable DTT. However, certain DTTs (eg, with the US, Ireland, Sweden, Ukraine) provide that no tax exemption applies to capital gains out of disposal of land-rich companies.

Capital gains/losses realised by a Bulgarian corporate shareholder are reflected in the year-end tax result (taxable at 10% if at a tax profitable position). Capital gains/losses out of share deals executed on a regulated EU/EEA market are not tax recognised.

Real estate transfer tax

The transfer of real estate, as well as of limited property rights over real estate, is subject to real estate transfer tax. The term “real estate” is defined in the Property Act. Under this definition, real estate is land, buildings and other structures and, in general, everything that is firmly fixed to the land or the structure.

The real estate transfer tax rate is determined by each municipality between 0.1% and 3%. The tax base is the higher between the sales price of the property and its tax value.

Registry fee of 0.1% and certain notary fees capped at 6,000 BGN (approx. 3,000 EUR) are also due upon acquisition of property.

Generally, these taxes and fees are due from the buyer. However, the parties can make other arrangements. If they agree to split the taxes and fees, by law, they will be jointly and severally liable for these. If they agree that the seller will pay the taxes and fees, the buyer will be considered guarantor of the payment. The notary who executes the notary deed on the transaction checks if the transfer taxes and fees have been paid.

Within seven days of buying the property, a foreign buyer should register for statistical purposes at the local BULSTAT registry office. This registration would be used for identification of the investor before the Bulgarian authorities.

The buyer should also file with the municipality a tax registration form within two months of the acquisition.

No real estate transfer tax obligation arises, if the property is transferred to a company in the form of an in-kind contribution.

Real estate transfer tax paid to the Bulgarian municipalities is to be capitalised into the value of the respective property.

Value-added tax (VAT)

If VAT is to be levied, then generally the tax base for VAT purposes is the sales price of the real estate, increased with the due transfer taxes and statutory fees, if the following conditions are simultaneously met:

- the taxes and fees are paid in the name and on behalf of the supplier; and
- the supplier requests them.

The VAT liability arises when the ownership of the property is transferred or when a payment for the acquisition of the property is made, whichever occurs earlier.

Use of separate property holding companies

Common practice is for foreign investors to invest in real estate in Bulgaria through separate special purpose vehicles. The subsequent sale of the real estate through a share deal instead of an asset deal would not be associated with transfer tax and VAT liabilities related to the respective real estate.

Financing real estate

Debt financing

Thin capitalisation and interest limitation

As elaborated above, interest expenses may not be fully tax deductible in the year when accounted for, if restricted under the thin capitalisation regime. The regime applies if the debt-to-equity ratio (D/E) of the company exceeds 3:1 for the respective year (calculated based on average values as at 1 January and 31 December). If the thin capitalisation regime is triggered, regulated interest expenses are tax deductible only up to a certain percentage of the company's EBIT.

Interest under bank loans/financial leases is generally not regulated under the thin capitalisation regime, unless the transaction is between related parties or the bank loan/lease is guaranteed by a related party or extended at their request, etc. Interest and other loan-related expenses capitalised in the value of an asset in accordance with the applicable accounting standards, as well as interest expenses not recognised for tax purposes on other grounds, would be outside the scope of the thin capitalisation restrictions. Restricted interest expense in a given year, may be utilised (deducted for tax purposes) in subsequent years if there are sufficient profits (no time limitation applies).

As of January 2019, in parallel to the existing thin capitalisation regime, new interest limitation rules are introduced to the Corporate Income Tax Act, transposing the so-called ATAD (Anti-Tax Avoidance Directive) of the EU[2]. Under the new interest limitation regime, net borrowing costs are tax deductible in the year when incurred, only up to 30% of the company's tax adjusted EBITDA. If the net borrowing costs for the year are up to 3 million EUR, the interest limitation regime does not apply (but the thin capitalisation regime may still apply). Any resulting non-deductible borrowing costs can be carried forward and deducted in future years without a time limitation based on a special formula.

Foreign exchange differences

Foreign exchange fluctuation on receivables and payables in a currency that is different from euro (the Bulgarian currency is linked to the euro) are accounted for on an accrual basis and are recognised for tax purposes if converted as per the Bulgarian National Bank's exchange rates.

Transfer pricing

Under the Bulgarian transfer pricing rules taxpayers should determine their taxable profits and income by applying the "arm's length" principle to prices at which they exchange goods, services and intangibles with related parties. Interest on loans provided by related parties should be consistent with the market conditions effective at the time when the loan agreement is concluded.

In case the conditions on transactions between related parties are not "arm's length"-based, the tax authorities may challenge the deductibility of the respective expenses or increase the taxable profit and levy additional corporate income tax. Amounts accrued, paid or distributed in any other form (except dividends) to shareholders (or their

[2] Council Directive (EU) 2016/1164 of 12 July 2016

related parties) without business justification or above market price level may be considered as hidden distribution of profits. That can lead to adverse tax implications.

As of FY 2020, Bulgarian entities, as well as foreign entities acting through permanent establishments in Bulgaria, which participate in cross-border related party transactions will be required to prepare mandatory transfer pricing documentation, if as of 31 December of the preceding year they exceed certain thresholds.

Withholding tax

As mentioned above, interest paid to non-resident lenders is subject to WHT at the rate of 10%. The rate may be reduced in accordance with the relevant DTT or the EU Interest and Royalties exemption regime as introduced in the domestic legislation.

Reporting duty

Bulgarian taxpayers are subject to certain statistical reporting obligations, eg, to declare any loans of more than 50,000 BGN received from abroad to the Bulgarian National Bank within 15 days of conclusion of the loan agreement – the declaration is a standard procedure and is for statistical purposes only. The status of the loan should be reported quarterly to the Bulgarian National Bank.

Equity financing

Increase of registered share capital

According to the Bulgarian Commerce Act, certain formal procedures are to be followed in terms of increasing the registered share capital of a Bulgarian LLC or JSC. The registered capital can be increased either with cash or by an in-kind contribution. Debt financing is also a practical approach used when investing in real estate.

Other contributions

Pursuant to the Bulgarian Commerce Act, monetary contributions can be made to a company without reflecting their value in the company's registered capital. These are usually calculated pro rata on the basis of the value of the shares held by the respective shareholder and are subject to repayment by the company, unless otherwise resolved by the shareholders.

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All information used in this content, unless otherwise stated, is up to date as of 23 July 2020.

Real Estate Tax Summary

General

Non-resident investors may invest in property in Canada through direct ownership of the property from offshore or through a Canadian resident corporation, partnership, or trust.

The ownership structure chosen may depend on commercial factors, the location of the property to be acquired in Canada, and the jurisdiction of the investor.

Acquisition of property by a non-resident

The purchase price paid for the acquisition of a property will form the tax cost of the acquired land and building. The portion of the purchase price that is allocated to the building can be depreciated for income tax purposes as capital cost allowance (CCA), discussed below. For this purpose, the allocation of the purchase price should be based on the fair market value of each of the land and building. There is no prescribed allocation ratio.

Any incidental expenses related to the acquisition of a property are capitalised to the cost of the land and building. The capitalisation of the incidental expenses to land and building should be based on the direct purpose for which the expenses were incurred. For example, if an expenditure incurred directly relates to the building, the expense should be capitalised to the cost of the building. However, if the expenditures relate to both land and building, it may be appropriate to use the fair market value allocation ratios. Types of incidental expenses include land transfer tax and registration fees, brokerage fees, legal fees and accounting fees.

Costs incurred to set up a corporation are deductible up to 3,000 Canadian dollars (CAD). The portion of the expenditures in excess of 3,000 CAD is not immediately deductible, but instead is deductible over time in a manner similar to tax deductions for depreciable property. Under these rules, the excess portion of the expenditure would be eligible for tax depreciation (CCA) at a rate of 5% per annum, on a declining balance basis.

Costs to obtain financing are deductible, rateably, over a five-year period, but adjusted in the case of a taxation year shorter than 12 months. If the financing is repaid in full during the amortisation period, the unamortised financing costs become deductible immediately.

Rental income

The taxation of Canadian source rental income earned by non-residents depends upon whether it is characterised as income from carrying on a business, or income from property. As a general proposition, the greater the level of services that are provided to the tenants, the more likely it is that the landlord will be considered to be carrying on a business. There is a rebuttable presumption that the income earned by a corporation in the exercise of its corporate objectives is income from a business.

If rental income received by a non-resident, through direct acquisition, is considered to be income from property; the rents paid or credited by a person resident in Canada to the non-resident person will generally be subject to withholding tax at the rate of 25% on the gross rents. Applicable tax treaties may reduce the percentage withheld.

The non-resident can elect, however, to pay tax on the net rental income as if they were a resident of Canada. The non-resident who makes this election may only deduct reasonable expenses incurred in earning the rental income, including tax depreciation or CCA. The CCA cannot generally be used to produce a rental loss. It is the position of the tax authorities that the election applies with respect to all income from real property and cannot be made in respect of individual properties. The non-resident pays tax on the net rental income at the rate that would be applicable if the non-resident person were resident in Canada. The federal rate of tax applicable on the net rental income would be 25%. If the property is located in the province of Quebec, an additional Quebec provincial tax of 11.5% would be applicable.

The non-resident will still be required to pay withholding tax of 25% on the gross rents received unless an election is made, jointly with a Canadian agent, to allow the agent to remit withholding tax on a net basis. CCA and other non-cash expenses are not deductible in determining the net amount on which withholdings are based. The election is not permanent, and the non-resident who has made the election in a particular year may decide not to make the election in a subsequent year. When an election is made to pay tax on net rental income, the non-resident must file a tax return within six months after the year-end. Where an election is not made, the non-resident

may file a tax return within two years after the end of the year. Amounts withheld will be credited against the actual tax liability, with any excess refunded following the assessment of the tax return.

If rental income received by a non-resident is considered to be business income, the gross rents will generally be subject to the same 25% withholding tax, unless the non-resident obtains a waiver and undertakes to file a Canadian income tax return with respect to its Canadian sourced income. The rate of tax applicable depends on the character of the non-resident (ie, an individual, corporation, or trust) and the province or territory in which the property is located.

If a non-resident acquires the property through a Canadian corporation or a Canadian-resident trust, the corporation or trust will pay tax in Canada at the applicable federal and provincial tax rates for that year. These rates vary depending on which of Canada's ten provinces and three territories the property is located in.

Tax depreciation (CCA)

Non-residents are generally subject to the same rules relating to depreciable property and CCA which apply to a resident of Canada. However, a non-resident person cannot claim CCA in respect of property situated outside Canada. Depreciation, as determined for accounting purposes, is not deductible.

Tax depreciation on buildings is calculated on a declining balance basis at the rate of 4% (or 6% for Canadian buildings constructed after 19 March 2007), subject to a 50% reduction to the full tax depreciation rate in the first year in which the building becomes available for use. The costs of additions to buildings and replacements of building components that are capital in nature are added to the tax cost for depreciation purposes.

Eligible property acquired after 20 November 2018 and available for use before 2024 may qualify for accelerated tax depreciation during the year in which the property becomes available for use, to effectively allow for that year the application of 1.5 times the full tax depreciation rate to the cost of the additions. Eligible property that becomes available for use between 2024 and before 2028 may qualify for the application of the full tax depreciation rate to the costs of additions in the year in which the property becomes available for use.

CCA is based on pools, with separate tax classes provided for various types of property. The deduction for CCA is always calculated on the tax cost of the entire pool. Most rental properties (ie, buildings held principally for the purpose of earning revenue that is rent and which cost more than 50,000 CAD) are required to have separate tax pools such that CCA is claimed on a property by property basis as opposed to being claimed on a combined pool of properties. This also creates the possibility of depreciation being recaptured on the sale of each individual property.

CCA cannot be claimed on a rental property to create or increase a tax loss unless the CCA claim is being made by a corporation, the principal business of which is the leasing, rental, development or sale of real property.

Thin capitalisation

The Canadian thin capitalisation rules may apply when the lender to a Canadian corporation or trust (or a corporation or trust that is not resident in Canada but carries on business in Canada or has elected to pay tax as if it was a resident of Canada) is a non-resident person who, alone or with other related persons, owns more than 25% of the corporation's shares or of the beneficial interests in the trust, and interest expense on the loan would otherwise be deductible to the corporation or trust. If the ratio of these debts to equity exceeds 1.5:1, the interest on the excess is not deductible.

The thin capitalisation rules will also apply, as described above, to debts owed by a partnership in which such a corporation or trust is a member.

Disallowed interest of a Canadian corporation or trust under the thin capitalisation rules will be deemed to be a dividend for Canadian withholding tax purposes that will be subject to dividend withholding tax of 25%, which may be reduced under a tax treaty.

Recent changes to the Canadian thin capitalisation rules can apply in respect of certain situations that involve secured guarantee arrangements in respect of third-party debts that would otherwise not be subject to the thin capitalisation limitations. In general terms, the changes apply where a non-resident person that does not deal at "arm's length" (i) pledges property to secure the debt, and the lender has at that time the right to use, invest or dispose of the property (ii) holds limited recourse debt of the third party lender; or (iii) makes a loan to the third party lender on condition that the loan be made to a Canadian corporation or trust. If the rules apply, the "arm's length" debt is treated as an intercompany loan.

Deductibility of fees paid to related parties

Fees paid to related parties are generally deductible if reasonable in the circumstances and incurred for the purpose of gaining or producing income from the business or property. However, the level of fees must be supportable and may not exceed what an “arm’s length” party would pay for the services being performed.

Currency issues

Foreign exchange gains or losses on account of income (ie, relating to operations) are generally considered currently taxable/deductible. However, foreign exchange gains or losses on account of capital (ie, relating to capital items such as fixed assets or debts) are only taxable/deductible when realised. Realised foreign exchange gains or losses on account of capital are treated as capital gains or losses for tax purposes in the period in which the gain or loss is realised. Only 50% of a capital gain or loss is subject to tax. A capital loss is only deductible against capital gains.

Gains or losses on hedging of currency exposures will be treated as either on account of income or on account of capital depending on the nature of the item being hedged.

Where a corporation has a functional currency other than the Canadian dollar, an election may be available in certain circumstances to compute and pay income tax in the corporation’s functional currency.

Disposition of property by a non-resident

A non-resident will be liable to pay Canadian income tax where there is a disposition of taxable Canadian property (TCP). TCP broadly includes (i) direct investments in real property located in Canada, (ii) shares of resident and non-resident private corporations, an interest in partnership or an interest in a trust (other than a mutual fund trust), where the shares or interest derive (or have derived at any time in the previous five-year period) more than 50% of their value from real property located in Canada and, (iii) shares of a corporation listed on a designated stock exchange, shares of a mutual fund corporation or units of a mutual fund trust, if a non-resident shareholder owns 25% or more of the issued shares or units of any class of the corporation or trust at any time during a five-year period and more than 50% of the value is derived at that time from real property located in Canada.

Where there is a disposition of non-depreciable capital property (eg, land), the non-resident is subject to Canadian tax on the taxable capital gain, ie, 50% of the gain (proceeds of disposition less capital cost of the property), at the tax rate that would apply if the non-resident were a resident of Canada.

In addition to being subject to Canadian tax on any taxable capital gain on the disposition of depreciable property (eg, a building), to the extent that proceeds of disposition exceeds the property’s undepreciated capital cost, the excess amount (up to the capital cost of the property) is taxable to the non-resident, at the tax rate that would apply if the non-resident were a resident of Canada, as recaptured depreciation.

A non-resident who disposes of property is required to report the entire amount of any taxable gain and/or recaptured depreciation resulting from the disposition in the year of disposition, even though all or a portion of the proceeds may not be due until after the year of disposition.

The non-resident in most situations will be required to report the transaction and make an advance payment on account of their tax liability before the disposition occurs. If the non-resident fails to do so, the purchaser is required to withhold a portion of the purchase price and remit the withheld amount to the Canada Revenue Agency.

Where the disposition is on income account (ie, non-capital trading assets such as inventory), the non-resident will be taxed on the resulting profit less applicable expenses, subject to possible relief by tax treaty.

Loss carryforwards

In determining the deductibility of losses, a distinction between losses from property and losses from business must be recognised. Losses incurred in the year by a non-resident from property, whether inside or outside Canada, are not deductible and cannot be carried back or forward. However, losses incurred in a taxation year from a business carried on in Canada are deductible from income, other than income from property, which is subject to tax in Canada for the year. Such losses, if not used in the current year, can be carried back three years and carried forward 20 years. However, losses of a non-resident from a business carried on outside Canada are not deductible in Canada.

Capital losses, resulting from the disposition of taxable Canadian property of a capital nature, can be carried back three years, and forward indefinitely, to reduce taxable capital gains from taxable Canadian property in those years.

Withholding taxes

Certain amounts paid or credited by Canadian residents to non-residents, such as interest on related party debt, interest in respect of participating debt arrangements, dividends, rents, or royalties, are subject to a withholding tax of 25% on the gross amount of the payments. Interest paid to “arm’s length” non-resident lenders is generally exempt from Canadian withholding tax, unless the interest is paid in respect of a participating debt arrangement. The rate of the withholding taxes may be lower under applicable tax treaties. Exceptions to the above may exist for certain payments.

Other relevant taxes

A non-resident may be subject to the 5% federal goods and services tax (GST), similar in application to the European VAT, on the purchase of real property and on certain expenses incurred in connection with the operation of the property, although such GST paid is usually recoverable (subject to significant restrictions in respect of residential rental properties). In most cases, a landlord is required to collect and remit GST on commercial rents received. However, a non-resident vendor of real property is not generally required to collect GST on the sale of real property.

In addition, most provinces impose a sales tax or have harmonised their sales taxes with the GST. The harmonised sales taxes function as the GST, described above. However, to the extent that a non-resident owns a property in a province that imposes a sales tax that is not harmonised with the GST, the non-harmonised sales tax will represent a non-recoverable additional cost on certain expenses incurred in connection with the operation of the property.

Many provinces and some municipalities in Canada levy a land transfer tax on the purchaser of real property (land and building) located within their boundaries. The tax is expressed as a percentage, occasionally on a sliding scale, of the sales price or the assessed value of the property purchased. Rates may be up to 4% (combined provincial and city rates) on the value of commercial property depending on the location of the property. Some jurisdictions impose additional land transfer tax on the acquisition of residential property. The tax is generally payable at the time the legal title of the property is registered or on the transfer of a beneficial interest. It may be possible to avoid land transfer tax in certain provincial jurisdictions depending on the structuring.

Some provinces have introduced additional taxes imposed on non-residents who acquire residential property within specific geographic areas within the province. These may be as high as 20% of the value of the property and where applicable, would apply in addition to land transfer tax.

In addition, most cities and towns impose an annual realty and/or business tax on real property. These taxes are based on the assessed value of the property at rates that are set each year by the various municipalities.

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China

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax & Investment Summary

General

Introduction

This guide comprises an overview of the tax and legal aspects relating to investment in the real estate industry in China. It is not intended to be comprehensive and consequently should only be relied on as an introduction to general matters relating to Chinese property law and tax.

We have excluded from this guide the specific rules relating to operators who buy and hold property as stocks with the intention of resale.

The tax aspects are considered with respect to investments made by corporate investors under the ultimate control of non-resident corporate investors. We have also included key information on investments realised by individuals.

Foreign investment control

The real estate industry no longer belongs to “restricted foreign investment industries” in China based on the Special Administrative Measures (Negative List) for Foreign Investment Access (Edition 2020).

Foreign investors are required to establish a real estate development Foreign Investment Enterprise (FIE) in China to undertake infrastructure construction, building construction, sales and lease of properties.

Generally, foreign investors are not restricted to engage in the development and construction of common residences. However, foreign investors are not allowed to use their equity interests of a real estate enterprise to invest in another enterprise in China.

Direct investments in Chinese real estate

Legal aspects

Ownership and leasehold

In China, the state government holds the ownership of all the land used for real estate development. Enterprises or individuals only have a land use right (ie, leasehold or state-owned land use right) and the ownership of the property built on the land. Generally, leasehold of the land for common residence purpose is 70 years, which can be renewed automatically upon the expiration of the term with or without the payment of land premium pending for further clarifications. The leasehold of the land for commercial, tourism or recreational purpose is 40 years and 50 years for the other purposes, such as industrial, educational, scientific, technological, cultural, public health, sports or comprehensively use.

Corporate & regulatory issues

Legal form

As above mentioned, foreign investors are required to establish real estate FIEs in order to undertake infrastructure construction, building construction, sales and lease of properties in China. In general, since 1 January 2020, a real estate development FIE can take one of the following four legal forms:

(i) wholly foreign owned enterprise (WFOE),

(ii) Sino-foreign joint venture (“the JV”),

(iii) foreign invested company limited by shares; or

(iv) foreign invested partnership (FIP).

The WFOE and the JV taking the limited liability company status are still the most popular legal forms used by foreign investors to set up real estate FIEs.

The legal form of the foreign invested company limited by shares usually will only be considered when the FIE intends to go for public, so this legal form is rarely used in private company sector.

The FIP is a relatively new form of investment in China with the general advantages of flexibility and tax efficiency, due to the uncertainty of its eligibility and competence for applications of various operating permits and qualifications required for real estate business operations, it seems no real estate FIE has taken the legal form of FIP as according to our general public search.

Conditions for establishment

According to Chinese laws, the following requirements shall be satisfied for the establishment of real estate development FIEs:

- having a minimum registered capital of 1 million Chinese yuan renminbi (CNY);
- having at least four certified full-time professionals in real estate and/or construction engineering;
- having at least two certified full-time accountants; and
- having completed approval procedures in accordance with the relevant People's Republic of China (PRC) regulations concerning the establishment of FIEs.

In addition, the local PRC government as authorised by Chinese laws may set out more stringent requirements in respect of the above-mentioned capital and professional staff requirements.

Real estate development qualification

Real estate development qualification ("Development Qualification") is a requisite for a real estate FIE to officially start and carry out development activities in China. There are in total four different levels of Development Qualifications ranging from Grade 4 as the lowest level to Grade 1 as the highest level. Different conditions and criteria must be met in different grades to allow development projects of different scales. For newly established real estate FIE, a temporary grade qualification for a period of one year is usually required to start development activities in China. After one year of experience, a Grade 4 or Grade 3 qualification can then be applied for.

Corporation tax aspects

Corporate income tax (CIT)

Enterprises shall pay CIT on income derived from sources inside and outside China. The CIT rate is 25%.

Provisional CIT is imposed on proceeds of the pre-sales of properties by a property developer based on the deemed profit rates which are generally ranged from 3% to 20%. In the major cities in China, such as Beijing, Shanghai, Guangzhou and Shenzhen, the deemed profit rates are as high as 15% or 20%.

Withholding tax (WHT)

Foreign enterprises which have no establishment or place of business in China or which have an establishment or place of business in China, but the income derived is not effectively connected with such establishment or place of business should pay WHT on China sourced income. The WHT rate in China is 10%. Generally, passive income such as dividend, interest and royalty distributed by the FIE to the foreign investors should be subject to 10% WHT. For the capital gain derived from the equity transfer of the project company in China, 10% WHT will be levied. The WHT rate may be lower if applicable to treaty benefit.

Value-added tax (VAT)

Sales of property and rental of property are subject to VAT effective from 1 May 2016. The taxable income is sales proceeds of property or rental of property. The applicable VAT rate is either 9% or 5% depending on the status of the taxpayer and the property.

Land value appreciation tax (LVAT)

The land value appreciation amount is subject to LVAT with progressive tax rates from 30% to 60%. For sales of an ordinary standard property unit, LVAT can be exempted if the appreciation portion is not exceeding of 20% of the amount of deductible items.

Provisional LVAT is also imposed on proceeds of the pre-sales of properties, reviewed by a property developer at the rates ranging from 2% to 8% in generally case. A project with a higher appreciation is subject to higher provisional LVAT rate.

Real property tax (RPT)

For a real property owned by the enterprise, 70% to 90% of the appraised value is subject to RPT at the rate of 1.2% per annum. For the rental property, rental value is subject to RPT at the rate of 12% per annum.

Deed tax (DT)

Purchase, transfer or exchange of property is subject to DT at rates ranging from 3% to 5%. The taxable amount is the transaction value.

Land use tax (LUT)

Enterprises which hold the land use right should pay LUT based on the area of the land. Generally, LUT is ranging from 0.6 CNY to 30 CNY per square metre. In big cities, the LUT rate is higher.

Stamp duty (SD)

For transfer of property, SD will be imposed on the sales price at the rate of 0.05%. For leasing of property SD will be imposed on rental income at the rate of 0.1%. For construction contracts, SD will be imposed on the construction price at the rate of 0.03%.

Thin capitalisation rules

The China Corporate Income Tax Law (effective from 1 January 2008) has introduced the concept of thin capitalisation rules. The purpose is to disallow the deduction of interest expenses pertaining to debts from related parties when the ratio of debt to equity exceeds a certain prescribed debt/equity ratio. The interest expenses shall include interests, guarantee fees, mortgage fee, etc.

There are two prescribed debt/equity ratios – one for enterprises in the financial industry and the other one for non-financial enterprises. The former is set at 5:1, while the latter at 2:1. As such, real estate enterprises are subject to the ratio of 2:1. Where the ratio of the debts from related parties to the equity exceeds the certain ratio in a year, the interest expense pertaining to the debts from related parties shall not be deductible in that year (and no carry-forward to future years), except in the following situation:

The excessive interest expenses may still be deductible if an enterprise can provide documentation to support that the inter-company financing arrangements comply with the “arm’s length” principle; or if the effective tax rate of the borrowing enterprise is not higher than that of the lending enterprise in China.

Furthermore, the non-deductible outbound interest expense paid to overseas related parties would be deemed as a dividend distribution and subject to WIT at the higher of the WIT rate on interest and the WIT rate on dividends.

Individual tax aspects

Individual income tax (IIT)

Generally, individuals should pay IIT on gain derived from disposal of property. The applicable IIT rate for the disposal of property is 20% on gain for the disposal of non-residential property. For the disposal of residential property, if the residential property has been used by the individual for more than five years and is the only residential property owned by the individual’s family, IIT can be exempted. For the disposal of residential property which has not been self-used by the individual over five years, IIT will be levied at the rate of 20% on the gain.

If the exact gain on disposal of properties cannot be ascertained, IIT is imposed on the gross sales proceeds based on the deemed tax rate generally ranging from 1% to 3%.

Rental income of property derived by individuals is subject to IIT.

Value-added tax (VAT)

Sales of property and rental of property are subject to VAT effective from 1 May 2016. The taxable income is sales proceeds of property or rental of property. The applicable VAT rate is set out as the following:

- 5% for sales proceeds of property;
- 5% for rental of non-residential property or 1.5% for rental of residential property.

VAT exemption is available for sales of property. The sale of residential property that has been bought for two years or longer by any individual may be exempted from VAT. This policy applies to regions other than Beijing, Shanghai, Guangzhou City, and Shenzhen in China.

Real property tax (RPT)

For individual residential property, the rental value is subject to RPT at the rate of 4% per annum. For individual non-residential property, rental value is subject to RPT at the rate of 12% per annum.

Composite rate for combined filing

In practice, tax authorities in different cities in China may adopt different concessional local practices for enforcement of tax collection from individuals in relation to their rental income from properties. For example, in Shanghai and Beijing, the composite rate at either 2.5% or 4% of gross rental is applied (which includes IIT, VAT, RPT and local surcharges) for individual residential property. While the applicable composite rate for individual non-residential property is either 2.5% or 4% in Shanghai, the applicable composite rate is either 7% or 12% in Beijing.

Stamp duty (SD)

For transfer of property, SD will be imposed on the sales price at the rate of 0.05%. For leasing of property SD will be imposed on rental income at the rate of 0.1%.

Land use tax (LUT)

For individual residential property, the LUT is exempted. For individual non-residential property, LUT should be paid based on the area of the land. Generally, LUT is ranging from 0.6 CNY to 30 CNY per square metre. In big cities, the LUT rate is higher.

Acquisition of a real estate enterprise via equity deal

Tax aspects

Value-added tax (VAT)

Generally, the sale of equity invested in a real estate enterprise is not subject to VAT.

Corporate income tax (CIT)

Gain on disposal of equity derived by an enterprise in China is subject to CIT at the rate of 25%. Gain on disposal of equity interest derived by a non-PRC enterprise is subject to WHT at the rate of 10%.

Land value appreciation tax (LVAT)

Generally, LVAT is not applicable to equity transfer. However, if the equity to be transferred is in relation to an enterprise whose major assets are real estate properties, it is possible for Chinese tax authorities to deem the transaction as indirect transfer of real estate property. If this is the case, LVAT is triggered if there is appreciation in value of real estate property. The appreciation amount is subject to LVAT at progressive rates from 30% to 60%. For sales of ordinary standard property units, LVAT can be exempted if the appreciation portion is not in excess of 20% of the amount of deducted items.

Construction issues

Legal aspects

Generally, the following certificates need to be obtained during the course of a real estate development project with the last three items required usually for commodity residence real estate project:

- state owned land use right certificate;
- construction land planning permit;
- construction project planning permit;
- construction permit for construction project;
- certificate of the completion of the project acceptance;
- real estate sales permit;
- commodity residential quality guarantee; and
- commodity residential use brochures.

Building works

Construction

Foreign investment in construction sector is officially allowed in China. A construction FIE needs to obtain the required qualification certificate before it could engage in the relevant activities. In general, qualifications of construction enterprises are classified into three categories, general contracting qualification, professional contracting qualification and construction labour service qualification.

Tax aspects

Corporate income tax (CIT)

A construction enterprise shall pay CIT on profit derived from sources inside and outside China at the rate of 25%.

Value-added tax (VAT)

Construction service income is subject to VAT at either 3% or 9% depending on the status of the construction enterprise and the status of the construction project.

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Real Estate Investments

Legal

EU nationals

There are no restrictions on the acquisition of immovable property by:

- EU citizens with the nationality of an EU or EEA state, and
- companies incorporated under the law of a state of the EU or EEA with their registered seat, central management or main establishment in the EU or EEA.

Non-EU nationals and companies

For non-EU individuals and non-EU companies the provisions of the Acquisition of Immovable property ("Aliens") Law, Cap. 109, apply. The law requires non-EU individuals and non-EU companies wishing to acquire real estate in Cyprus, to obtain permission from the Council of Ministers of the Republic of Cyprus to acquire real estate in Cyprus.

The procedure for requesting such permission is straight forward and applications are handled by the local District Administration Office in the district where the real estate is located. There are regulations and internal guidelines relating to the number and size of real estate to be purchased and its use which regulate the granting of such permission.

Citizenship and permanent residence for real estate investors

Cyprus offers citizenship and/or permanent residence permits, under investment conditions, which include criteria relating to the acquisition of real estate in Cyprus.

Tax

Rental income

Rental income derived from Cyprus immovable property is taxable in Cyprus.

If the property owner is a company (whether resident or non-resident) the corporate tax rate of 12.5% applies.

If the property owner is an individual, rental income is added to other Cyprus taxable income of the individual and the following personal income tax (PIT) rates apply:

Chargeable income for the tax year (in euro)	Tax rate* (in %)	Accumulated tax (in euro)
0 to to 19,500	0	0
19,501 to 28,000	20	1,700
28,001 to 36,300	25	3,775
36,301 to 60,000	30	10,885
60,001 or more	35	

*currently applying in 2020

Property running expenses incurred in deriving rental income such as insurance, repairs and maintenance, and property management fees as well as any other expenses incurred wholly and exclusively for the production of rental income are deductible if the owner of the Cyprus-situated immovable property is a company.

Individuals are not allowed to deduct such actual expenses (other than interest expenses and capital allowances), but instead can deduct a notional 20% on the gross rental income from buildings (ie, land not included), independent of whether any actual expenses were incurred in deriving the rental income or not.

In regard to the Cyprus-situated immovable property on which rental income is earned, the deductions could additionally include any interest expense accruing on borrowings that were obtained by an individual or a company to finance the acquisition of the building.

Capital expenditures such as stamp duty and legal costs incurred in acquiring the property are not deductible, but form part of the acquisition for tax depreciation allowances and for costs deductible against sales proceeds realised upon potential disposal of the property.

Refer also to the section "*Special contribution for defence (SDC)*".

Tax credits for voluntary reduction of rent (applicable in tax year 2020 only)

As part of the measures taken by the Cyprus government towards supporting the Cyprus economy during the COVID-19 outbreak period, a company or an individual that earns rental income from immovable property should be eligible for a tax credit equal to 50% of the voluntary reduction of the monthly rental amount if the said reduction is both not higher than 50% and not lower than 30% of the monthly rental amount. The said company or individual should be eligible for the aforesaid tax credit provided that:

(i) The tax credit is for a maximum of three months within tax year 2020, irrespective of the number of months for which a rental reduction has been agreed;

(ii) The reduction of the rental amount is granted under a written agreement between the landlord and the tenant;

(iii) The landlord and the tenant are not related persons as defined under Corporate Income Tax Law;

(iv) The tax credit could be utilised against the total income tax charge of the landlord for tax year 2020; and

(v) Any refundable tax that relates to the said tax credit does not exceed the amount of tax that has been already paid.

Depreciation allowances

Annual tax depreciation allowance on the capital costs is available both to the individual and the corporate investors at the rate of 3% for commercial buildings, and 4% for industrial, agricultural and hotel buildings. For industrial and hotel buildings acquired during the tax years 2012-2018 (inclusive), an accelerated tax depreciation at the rate of 7% per annum applies. Buildings for agricultural and livestock production acquired during the tax years 2017-2018 (inclusive) are eligible for accelerated tax depreciation at the rate of 7% per annum. These rates are amended accordingly in case of second-hand buildings.

Upon disposal of the Cyprus-situated immovable property, a tax balancing allowance/charge is calculated on the difference between sales proceeds and the tax written down value. However, the maximum taxable profit which may be taxed under income tax resulting from a balancing addition is the total tax depreciation allowances previously claimed during the period of ownership.

Individuals who have been claiming tax depreciation allowances on Cyprus-situated immovable property from which rental income was derived are not subject to the balancing allowance/charge provisions upon disposal – such tax depreciation allowances are taxed under capital gains tax (refer also to the section "*Capital gains on the sale of property*". Further, balancing statements are not required in cases of tax-qualified company reorganisations.

Finally, land does not qualify for tax depreciation allowances.

Capital gains on the sale of property

Unless the seller is considered to be a trader in real estate (as per badges of trade), any gains realised upon disposal of immovable property situated in Cyprus will be subject to capital gains tax (CGT).

Having said that, subject to certain conditions, land as well as land with buildings acquired at market value (excluding exchanges and donations) from unrelated parties in the period of 16 July 2015 up to 31 December 2016 will be exempted from CGT upon its future disposal.

Disposal for the purposes of CGT specifically includes sale, exchange, lease, gift, abandoning use of right, granting of right to purchase, and any sums received upon cancellation of disposals.

Certain disposals of Cyprus-situated immovable property are not subject to CGT, for example, gifts from parent to child, or between husband and wife, or between up to third degree relatives, gifts to charities, expropriations, gifts to charities, etc (non-exhaustive list).

CGT at the rate of 20% is imposed (when the disposal is not subject to income tax) on gains arising from the disposal of immovable property situated in Cyprus including gains from the disposal of shares in companies that

own Cyprus-situated immovable property. CGT is also imposed on disposals of shares in companies that indirectly own immovable property situated in Cyprus where at least 50% of the market value of the said shares derives from Cyprus-situated immovable property.

Transactions in shares listed on any recognised stock exchange are exempted from CGT.

In the case of disposal of non-listed company shares, the gain is calculated exclusively on the basis of the gain relating to Cyprus-situated immovable property. The value of the immovable property will be its market value at the time the shares are disposed of.

The taxable gain is generally calculated as the difference between the disposal proceeds/market value as at disposal date and the original cost of the property plus any improvements as adjusted for inflation up to the date of disposal on the basis of the consumer price index in Cyprus. In the case of property acquired before 1 January 1980, the original cost is deemed to be the value of the property as at 1 January 1980 on the basis of the general valuation conducted by the Land Registry Office under the Immovable Property Law. To the extent that a portion of the original cost was already granted as an expense under income tax via claiming of tax depreciation allowances (and not clawed back via balancing statement at disposal stage), then this portion is not allowed for CGT purposes.

Other expenses that relate to the acquisition and disposal of immovable property are also deducted from the gain, subject to certain conditions (eg, interest expenses on related loans, transfer fees, legal costs).

The following lifetime exemptions are available to individuals:

Capital gain arising from:	**Deduction (in euro)**
Disposal of private principal residence (subject to certain conditions)	85,430
Disposal of agricultural land by a farmer	25,629
Any other disposal	17,086

The above exemptions are lifetime exemptions subject to an overall lifetime maximum of 85,430 EUR.

Dividends and withholding tax

No withholding tax is imposed on dividend payments to investors – both individuals and companies – who are non-residents of Cyprus in accordance with the Cyprus domestic tax legislation, irrespective of the percentage and period of holding of the participating shares. Therefore, no double tax treaty protection is needed.

Loss carryforward

The tax loss incurred during a tax year and which cannot be set off against other same year income, is carried forward subject to conditions and set off against the profits of the next five years. In addition, for corporate owners of the Cyprus-situated immovable property, provisions of group loss relief apply in respect of same year results.

Group relief (set-off of the income tax loss of one company with the taxable profit of another) is allowed between Cyprus tax resident companies of a group. A group is defined as follows:

- a Cyprus tax resident company holding directly or indirectly at least 75% of the voting shares of another Cyprus tax resident company; or
- both of the companies are at least 75% (voting shares) held, directly or indirectly, by a third company.

As of 1 January 2015, interposition of a non-Cyprus tax resident company/companies will not affect the eligibility for group relief as long as such company/companies is/are tax resident(s) of either an EU country or in a country with which Cyprus has a double tax treaty or an exchange of information agreement (bilateral or multilateral).

Capital tax losses may also be carried forward and set off against future capital gains tax profits without time restriction (but not group relieved).

Annual tax on immovable property situated in Cyprus

Immovable property tax (IPT) has been abolished as from 1 January 2017. Until tax year 2016, the owner of immovable property situated in Cyprus was liable to pay an annual IPT which was calculated on the market value of the property as at 1 January 1980, at varying rates and applied per owner and not per property.

Transfer fees and mortgage fees

The fees charged by the Department of Land and Surveys to the acquirer for transfers of Cyprus-situated immovable property are as follows:

Market value (in euro)	Rate (in %)	Fee (in euro)	Accumulated fee (in euro)
First 85,000	3	2,550	2,550
From 85,001 to 170,000	5	4,250	6,800
170,001 and more	8		

It is important to note that:

- no transfer fees are payable if VAT is applicable upon purchasing the immovable property.
- the above transfer fees are reduced by 50% in case that the purchase of immovable property is not subject to VAT.

Mortgage registration fees are 1% of the current market value.

In the case of companies' reorganisations, transfers of immovable property are not subject to transfer fees and mortgage registration fees.

Stamp duty

The general rule is that Cyprus stamp duty is imposed only on written instruments relating to assets located in Cyprus or relating to matters or things that are done or executed in Cyprus. Unless otherwise stipulated in the sale-purchase agreement, the purchaser is liable for the payment of stamp duty. The applicable rates are based on the value stipulated in each instrument and are nil for values up to 5,000 EUR, 0.15% for values from 5,001 EUR up to 170,000 EUR, and 0.2% for values above 170,000 EUR, subject to an overall maximum amount of stamp duty of 20,000 EUR per agreement. Exemption from stamp duty applies in the case of a qualifying reorganisation.

Special contribution for defence (SDC)

In addition to income tax (see section "*Rental income*") SDC is also imposed on rental income. SDC is imposed on gross rental income, reduced by 25%, at the rate of 3% (ie, at the effective rate of 2.25%) earned by Cyprus tax resident companies and Cyprus tax resident-domiciled individuals.

For Cyprus sourced rental income where the tenant is a Cyprus company, partnership, the state or local authority SDC on rental income is withheld at source and is payable at the end of the month following the month in which it was withheld. In all other cases the SDC on rental income is payable by the landlord in six monthly intervals on 30 June and 31 December each year.

Value-added tax (VAT) on immovable property

Leasing of immovable property

VAT at the standard rate must be charged on the lease of immovable property when the lessee is a taxable person and is engaged in taxable activities by at least 90%. The lessor has the right to opt not to impose VAT on the specific property. The option is irrevocable.

Sale of non-developed building land

VAT at the rate of 19% must be charged on the sale of non-developed building land, as from 2 January 2018. Non-developed building land is defined as any land intended for the construction of one or more structures in the course of carrying out a business activity. No VAT will be imposed on the purchase or sale of land located in a livestock zone or areas which are not intended for development such as zones/areas of environmental protection, archaeological and agricultural.

Repossession of immovable property by financial institutions

VAT must be accounted under the reverse charge provisions on transactions relating to transfers of immovable property during the process of loan restructuring and for compulsory transfer to the lender, as from 2 January 2018. As from 5 December 2019, the definition of the term “lender” includes licensed credit and financial institutions, credit acquiring companies, including their subsidiaries, as well as a public body or any licensed company which acquired/received from a credit institution any non-performing/overdue loans. This provision is effective until 31 December 2020.

Leases of immovable property which effectively transfer risks and rewards of ownership

As from 1 September 2018 leases of immovable property which effectively transfer the risks and rewards of ownership of immovable property are considered to be supplies of goods. They also become subject to VAT at the standard rate.

Acquisition and/or construction of residences used as primary and permanent place of residence

The reduced VAT rate of 5% applies to contracts that have been concluded from 1 October 2011 onwards provided they relate to the acquisition and/or construction of residences to be used as primary and permanent place of residence for the next ten years.

The reduced VAT rate of 5% applies on the first 200 square metres. The standard rate applies for the remaining square metres as determined based on the building coefficient. The reduced rate is imposed only after obtaining a certified confirmation.

The eligible person must submit an application on a special form, which will state that the residence will be used as primary and permanent place of residence. The applicant must attach a number of documents supporting the ownership rights on the property and evidencing the fact that the property will be used as primary and permanent place of residence. The application must be filed prior to the actual delivery of the residence to the eligible person.

Eligible persons include residents of non-EU Member States, provided that the residence in Cyprus will be used as their primary and permanent place of residence.

The documents supporting the ownership of the property must be submitted together with the application. The documents supporting the fact that the residence will be used as primary and permanent place of residence (copy of telephone, water supply or electricity bill or of municipal taxes) must be submitted within six months from the date on which the eligible person acquires possession of the residence.

A person who ceases to use the residence as primary and permanent place of residence before the lapse of the ten-year period must notify the Commissioner of Taxation within thirty days. The person must also pay the difference resulting from the application of the reduced and the standard VAT rate attributable to the remaining period of ten years for which the property will not be used as primary place of residence.

Persons who have already acquired a residence on which the reduced VAT rate was imposed, can reapply and acquire a new residence on which the reduced VAT rate will be imposed, irrespective of whether the ten-year prohibition period for using the initial residence has lapsed or not. A condition for this to apply is that in case the ten- year period of using the residence as primary and permanent place of residence has not lapsed, the persons must return the VAT difference between the standard and the reduced VAT rates applicable at the time of the acquisition or construction of the residence to the Tax Department.

Persons who make a false declaration to benefit from the reduced rate are required by law to pay the difference of the additional VAT due. Furthermore, the legislation provides that such persons are guilty of a criminal offence and, upon conviction, are liable to a fine, not exceedingly twice the amount of the VAT due, or imprisonment up to three years or may be subject to both sentences.

Renovation and repair of private residences

The renovation and repair of privately-used residences (for which a period of at least three years has elapsed from the date of their first use) is subject to VAT at the reduced VAT rate of 5%, excluding the value of materials which constitute more than 50% of the value of the services.

In addition, the renovation and repair of old private residences (for which a period of at least three years has elapsed from the date of their first use) and which are used as place of residence of vulnerable groups or residences that are used as place of residence and which are located in remote areas are subject to VAT at the reduced VAT rate of 5%.

Additional support measures to mitigate the effects of COVID-19 in the tourism industry

The Council of Ministers issued a Decree (published on 23 June 2020 in the Official Government Gazette) to reduce the VAT rate from 9% to 5% for the hotel and tourism industry including hotel accommodation services and letting for short term accommodation purposes through online platforms/websites. The reduced VAT rate of 5% will apply for the period from 1 July 2020 to 10 January 2021.

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Real Estate Going Global

Czech Republic

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

Introduction

The real estate sector in the Czech Republic kept a stable growth rate in Q1 2020, while being affected by the COVID-19 in Q2 2020. There are however positive signs for the remainder of the 2020. The tax environment remains stable and the pending legislative changes are aiming on incentivising the real estate market and number of deals.

Taxation

When investing in real estate in the Czech Republic, the following key points should be considered:

- In principle, Czech legal entities, Czech branches of foreign companies, and European Union (EU) individuals and entities may directly acquire Czech real estate, although certain restrictions remain in place.
- The general Czech corporate income tax rate for 2020 is 19% and there are currently no plans to amend the rate.
- Tax losses may, in principle, be carried forward for five tax periods immediately following the tax period in which the tax loss arose. As a measure to tackle down the COVID-19 impact, a two-year tax loss carry-back was introduced into the Czech legislation.
- Certain restrictions on the ability to redeem losses apply if there is a substantial change in the ownership of a company.
- Tax losses cannot be set off against the profits of a group company.
- Dividends and interest payments are liable to a withholding tax (WHT) rate of 15%. This rate may be reduced by a double tax treaty (DTT), if applicable. The 0% WHT rate applies to qualifying dividend distributions and interest payments, in accordance with the EU Parent-Subsidiary and Interest-Royalties Directives. The 35% WHT rate applies if the recipient is not resident of a country with which the Czech Republic has concluded an effective DTT or treaty on the exchange of tax related information.
- Both realised and unrealised foreign exchange (FX) differences are subject to corporate income tax (CIT) in the tax period in which they arise.
- Real estate acquisition tax is charged at the flat rate of 4% on the transfer of ownership title to real estate. As a measure to tackle down COVID-19 impact a proposal for abolishment of the 4% transfer tax is currently under approval process. It is expected that it will be approved, and the transfer tax will be abolished retrospectively for all transactions since 1 December 2019.
- No capital duty is levied in the Czech Republic.
- Thin capitalisation rules allow a debt-to-equity ratio of 4:1 for loans from related parties to restrict tax-deductible financial costs.
- A 30% earnings before interest, tax, depreciation and amortisation (EBITDA) interest tax deductibility restriction with an 80 million Czech korunas (CZK) “safe harbour” was introduced with the mandatory implementation of the EU Anti-Tax Avoidance Directive (ATAD).

Legal aspects

Ownership of real estate can be acquired through, eg, a purchase contract or donation, a contribution to a company, or inheritance.

A contract for the transfer of real estate must be in writing and the signatures must be verified. If real estate is transferred on the basis of a contract, ownership is acquired by its registration with the Real Estate Cadastre, according to specific regulations governing such a transfer (unless a special law provides otherwise).

Review of ownership titles is an important component of legal due diligence in the Czech Republic, because of the transformation of real estate evidence in the Czech Republic in the early 1990s and the previous regime, during which ownership rights were not properly entered into books.

Real Estate Investments

Investing through a local entity

Methods of acquisition

An investor may either establish a Czech legal entity that will directly acquire the real estate or acquire shares in a Czech special-purpose company that owns the property.

It is advisable to conduct a thorough due diligence review of the target company before acquiring its shares. In such a due diligence review, the legal, financial and tax positions of the company should be examined. Generally, the seller should be asked for certain representations, warranties and indemnities regarding the legal, financial and tax position of the company.

Choice of entity

Under the Czech Business Corporations Act, the following Czech legal entities may be established as business entities:

- general partnership (*verejna obchodni spolecnost*);
- limited partnership (*komanditni spolecnost*);
- limited liability company (*spolecnost s rucenim omezenym*);
- joint-stock company (*akciova spolecnost*); and
- Societas Europaea (*evropska spolecnost*).

All five types of entities may hold real estate, even if they are fully owned by foreign entities or foreign individuals.

A limited liability company and a joint-stock company are the most frequently used types of companies for holding real estate. A limited liability company may be founded by one or more resident or non-resident persons, who may be either legal entities or individuals. The minimum registered capital required for new limited liability companies to be founded is 1 CZK. The minimum investment by a participant is also 1 CZK.

A joint-stock company may be founded by one founder a legal entity or an individual. Proposed new joint-stock companies require a minimum share capital of 2 million CZK (80,000 EUR).

Tax

Corporate income tax

General aspects

Legal entities established in the Czech Republic, and foreign legal entities with their place of management in the Czech Republic, are taxed on both, their Czech and foreign-sourced income.

The basis for computing the taxable income of a company is the difference between the company's taxable revenues and its tax-deductible costs. Tax-deductible costs generally include depreciation of buildings, structures and other assets; repairs; maintenance; real estate tax paid; and other expenses incurred to generate, assure and maintain the company's taxable income. For a number of costs, it is explicitly stated in the law that they are tax non-deductible.

Czech tax law requires that transactions between related parties be carried out on an "arm's length" basis (ie, at usual market prices). If the price of a transaction differs from the price that would be agreed between independent persons under the same or similar business conditions, and the reason for this difference cannot be satisfactorily documented, the Financial Office may challenge the contracted price and adjust the tax base by the ascertained difference. It is possible to apply for binding transfer pricing rulings from the tax authorities.

Depreciation

With the exception of land, real estate is generally depreciable for tax purposes. Many acquisition-related expenses (such as architect's fees, lawyer's fees, notary's fees), should be capitalised as part of the cost of the relevant real estate. With regard to interest costs incurred before putting the asset into use, the taxpayer has the option to capitalise such interest costs or not.

Tax depreciation of buildings acquired through purchase may commence in the year when an application for the registration of ownership title is delivered to the Real Estate Cadastre, supposing that the ownership title is transferred, and the real estate is put into use.

In the first year of depreciation, tangible assets are to be classified into one of six depreciation categories, with minimum depreciation periods ranging from three to 50 years. The sixth depreciation category includes hotels, "administrative buildings" (such as office buildings), department stores and some other assets. The depreciation period for such assets put into use after 31 December 2003 is 50 years.

Generally, for newly acquired assets, the owner of the asset will determine the method of tax depreciation. Tax depreciation may be calculated using either the straight-line method or the reducing-balance method, whichever the taxpayer selects. The chosen method of depreciation cannot be changed during the depreciation period. A taxpayer has the right to stall, and then to recommence at a later time, claiming tax depreciation.

Special provisions need to be considered with respect to the tax treatment of fit-out works installed by the lessee in leased premises, in order to avoid disadvantageous tax impacts for both the lessor and the lessee, especially when lease agreements are terminated.

Withholding tax (WHT)

Dividends are subject to the 15% WHT rate. In the case of dividend payments to a recipient abroad, the relevant DTT may reduce this rate. The EU Parent-Subsidiary Directive is available to remove WHT on qualifying dividend distributions paid to shareholders in EU Member States or other qualifying Czech entities. However, the 35% WHT rate applies if the dividend recipient is not resident of a country with which the Czech Republic has concluded an effective DTT or treaty on the exchange of tax related information.

The dividend WHT is deducted at source and, for Czech purposes, is considered as the final tax liability. This implies that if the recipient is a Czech company or resident, they are not taxed on such dividend income.

Interest paid to non-resident recipients is subject to WHT at the rate of 15%. The rate may be reduced in accordance with a relevant DTT. As of 1 May 2004, the 0% WHT rate applies to qualifying interest payments, as a result of the implementation of the EU Interest-Royalties Directive. However, the 35% WHT rate applies if the interest recipient is not resident of a country with which the Czech Republic has concluded an effective DTT or treaty on the exchange of tax related information.

Value-added tax (VAT)

VAT is charged at three rates:

(i) the standard rate of 21%, which applies to most goods and services;

(ii) the first reduced rate of 15%, which in general applies to foodstuff and some other expressly listed goods and services; and

(iii) the second reduced rate of 10%, which applies to books, child food, pharmaceuticals and ingredients used in foodstuff for celiacs.

The transfer of vacant land is generally VAT-exempt; however, the sale of construction land is subject to VAT at the rate of 21%.

The transfer of unfinished structures (including buildings, houses) and the transfer of finished structures effected within five years after (i) the first use of the real estate started, or (ii) the very first approval for use of the real estate, whichever occurs earlier, are generally subject to VAT at 21%.

The transfer of residential buildings is subject to the standard VAT rate of 21% VAT; however, real estate that qualifies as "social housing" is subject to the first reduced VAT rate of 15%. According to the current definition of "social housing", a large portion of residential development will likely fit into this category. Provision of construction work related to finished residential buildings are subject to first reduced VAT rate of 15%.

Accommodation services in hotels are currently subject to the 15% VAT rate.

The sale of real estate after above stated period (or real estate acquired by the end of 2012) is VAT-exempt without the entitlement to claim input VAT. However, the vendor can decide to opt to apply VAT on sale of the real estate after the above mentioned period. Provided the purchaser is a VAT payer, this can be done only upon a consent of the purchaser. In such a case, local reverse-charge applies, ie, the purchaser will self-charge the VAT.

The rent of most real estate is generally VAT-exempt, but in certain situations it is possible to apply VAT on the rent. In this case, the applicable rate is 21%.

If a company registered for VAT purchases a building for entrepreneurial activities, it is, in principle, entitled to claim the related input VAT. A full refund will be granted if the building is only used for activities that generate taxable supplies. However, no refund will be granted if the building is only used for exempt supplies. A partial refund will be given if the building is used partly for taxable and partly for exempt supplies.

A change in the use of a building (eg, from non-exempt to exempt activities or a change in the ratio of use between non-exempt and exempt use) in the ten years subsequent to its acquisition may have an impact on the input VAT claimed. In certain situations, this may imply that part of the claimed input VAT has to be repaid. The VAT corrective adjustment also applies on repair/maintenance costs associated with real estate asset exceeding 200,000 CZK.

As of 1 January 2021, it will be no longer possible to apply VAT on rent of premises for living (eg, family houses, flats, or buildings where more than 60% of the space is intended for living), even when rented to another VAT payer and such lease will always be exempt from VAT without the entitlement to claim VAT on input. As such, taxpayers may be forced to return part of the VAT based on the above ten-year claw back rules.

From 2012, the construction and assembly works are subject to the reverse charge mechanism.

Real estate tax

Real estate tax is for most corporate owners a negligible cost despite an increase in real estate tax rates. This tax is generally recovered from tenants via service charges.

Direct investments in real estate

In some cases, it may be tax beneficial for a foreign entity to structure an acquisition of Czech real estate through a branch, even if registering a branch is as administratively demanding as incorporating a Czech company. Another significant determining factor will be the exit route. Generally, the same consequences as in the case of a direct sale of real estate by a Czech legal entity will apply, the most significant proceeds being subject to the real estate transfer tax rate of 4% (which should however be abolished) and capital gains being subject to the 19% CIT rate in the Czech Republic. If a share deal is preferred, this will likely imply that the shares in the foreign company owning the Czech branch need to be sold. This possibly reduces flexibility to a seller.

From a Czech point of view, there can be scope for savings of WHT on repatriation of profits from rental of the property, and different tax treatment applies to financing in respect of the amount of interest that can reduce taxable profits. VAT issues also need to be addressed.

Buying and selling property

Capital gains and losses on the sale of property or shares

There are no separate capital gains taxes. Capital gains are considered business profits and are as such, subject to income tax. Therefore, corporate owners of real estate are subject to CIT on capital gains realised on the sale of property in the Czech Republic, at the standard CIT rate. Capital losses on the sale of real estate, including land, are generally deductible for tax purposes.

If shares in a Czech entity are sold by one foreign shareholder to another, the capital gains derived from the sale of the shares is treated as Czech-sourced income and is, therefore, subject to Czech tax, irrespective of the residency status of the seller and purchaser. In cross-border situations, however, subject to the wording of the relevant DTT, the gain may be outside the scope of Czech taxation. Nevertheless, in certain DTTs (eg, between the Czech Republic and France), such an exemption does not apply if the assets of the entity of which the shares are sold consist only or predominantly of immovable property.

Capital losses from the alienation of shares in a limited liability company are not tax-deductible. The same treatment applies in general to joint-stock companies, although certain exceptions may apply.

Use of separate property holding companies

To avoid taxes on the disposal of the property, it is common practice to hold properties in separate special-purpose companies. Disposals are affected by selling shares in the property company.

It is important from the outset for the holding company to be located in a jurisdiction with an appropriate DTT and a tax system that refrains from taxing capital gains. The selection of an appropriate jurisdiction is therefore of considerable significance. A jurisdiction is less suitable if its DTT with the Czech Republic treats the sale of shares in a property holding company in the same way as the disposal of the underlying property.

Czech domestic law contains a participation exemption regime with regard to capital gains from the sale of shares in a subsidiary. One of the main conditions for applying the participation exemption is a minimum holding of 10% of shares in the subsidiary for an uninterrupted period of at least 12 months. The participation exemption can be applied to the transfer of shares in a Czech subsidiary and also in a company that is a tax resident in another EU Member State, or in a third country having a DTT with the Czech Republic.

Real estate acquisition tax (REAT)

The paid transfer of ownership title to real estate is subject to real estate acquisition tax (REAT). For REAT purposes, the term “real estate” is generally interpreted according to the definition of the Czech Civil Code. The Civil Code defines real estate as plots of land and structures connected to the land by a solid foundation.

REAT is charged at the flat rate of 4% which is payable by the buyer. The tax base is generally the sales price or 75% of an official valuation, whichever is higher. Fees paid for elaboration of official appraisal can reduce the tax base for REAT. REAT paid to the Czech tax authorities should be added to the acquisition value of acquired asset and claimed as tax-deductible cost via tax depreciation.

There are certain exemptions from REAT, one of them being the first paid transfer of new buildings, provided that certain conditions are met.

The transfer of real estate as a consequence of either a merger or consolidation with another company, the transformation of a company into another legal form, or as the result of the division of a company by a demerger process is generally not subject to REAT.

Please note that a proposal to abolish REAT is currently in the approval process and is expected to pass. The abolishment will have a retroactive effect for all real estate acquired since 1 December 2019.

Value-added tax (VAT)

If VAT is to be levied, then generally the tax base for VAT purposes is the sales price of the real estate (including land). The VAT liability arises on the day on which the real estate is handed over for use, or when the decision from the Land Register is received, whichever is earlier.

Financing real estate

Debt financing

Thin capitalisation rules

With the exception of thin capitalisation and transfer pricing rules, there are no specific rules in force that limit the tax deductibility of interest on loans for the acquisition of real estate or shares. As of 1 January 2004, interest on borrowings taken up to acquire shares is generally non-deductible, unless proved otherwise. Subject to thin capitalisation rules, expensed interest is generally fully tax-deductible, provided that financing was granted under “arm’s length” conditions and the interest was incurred for generating taxable income.

For thin capitalisation purposes, related parties are defined as entities that directly or indirectly participate in the management, control or capital of the recipient of the credit or loan. Participation in the control or capital means a shareholding exceeding 25% in the registered capital of the recipient of the funds borrowed.

Thin capitalisation limits are determined by the ratio of a company’s borrowings to its equity. Interest on the amount of debt exceeding these ratios is tax non-deductible. For tax purposes, such surplus amount is considered as a dividend (unless the dividend income is paid to a tax resident in another EU country or in another country being part of the European Economic Community) and, in case of payment to a non-resident, generally liable to the 15% WHT rate. This WHT may be reduced by relevant DTT.

The major features of the thin capitalisation rules are as follows:

- The tax-deductibility test applies to all so-called “financial costs on loans” (ie, interest plus other related costs, such as bank fees).
- The debt-to-equity ratio for related-party loans to equity is 4:1.
- Financial costs paid on profit participating loans are fully tax non-deductible.

ATAD consideration

Starting from January 2019, the borrowing costs are deductible in a tax period in which they are incurred only up to 30% of the taxpayer’s EBITDA.

At the same time, the taxpayer is given right to deduct borrowing costs up to 80 million CZK without the limitation, or to fully deduct borrowing costs if the taxpayer is a stand-alone entity (ie, not a member of a group).

The interest that is considered as tax non-deductible may be carried forward by the taxpayer to the following taxable periods with no restrictions.

The thin capitalisation rules and new rules limiting tax deductibility of interest apply simultaneously.

The Czech tax law also introduced anti-hybrid measures and may deny tax deductibility of interest in case there is not a corresponding pick-up and taxation of the interest income in higher tiers of the holding structure.

Foreign exchange differences

Unrealised FX differences on receivables and payables are, for accounting purposes, to be recognised and included in the profit and loss (P&L) account. Unrealised and realised FX differences are therefore treated similarly for accounting purposes. This will generally also be the case for the tax treatment.

Transfer pricing

Interest on loans provided by related parties should, as with all related party transactions, be charged at “arm’s length”. If this condition is not met, and the difference is not properly documented, the tax authority is entitled to increase the taxpayer’s tax base by the ascertained difference.

Withholding tax (WHT)

Interest payments abroad are usually liable to the 15% WHT rate. This rate may be reduced by the applicable DTT. As of 1 May 2004, the 0% WHT rate applies to qualifying interest payments between related parties, as a result of the implementation of the EU Interest-Royalties Directive. However, the 35% WHT rate applies if the interest recipient is not resident of a country with which the Czech Republic has concluded an effective DTT or treaty on the exchange of tax related information.

Equity financing

Increase of registered share capital

According to the Czech Commercial Code, certain formal procedures must be undertaken to increase the registered share capital of a Czech company. These are not further commented on in this publication.

Contribution into other capital funds

Czech legislation expressly states the possibility of making monetary contributions to the equity of a limited liability company that do not form part of the registered share capital. This non-registered equity is referred to as “other capital funds”. A contribution to the other capital funds account is administratively relatively easy, as it does not have to be registered with the Czech Commercial Register.

A contribution to other capital funds has no influence on the amount of the registered share capital. It should be also possible to repay contributions to shareholders, but only as far as losses have been covered.

A similar possibility to create other capital funds can exist in certain circumstances for joint-stock companies having a single shareholder.

Municipal tax

General

Real estate municipal taxes consist of two taxes:

- land tax; and
- building tax.

The administrator and collector of both taxes is the Financial Office of the district in which the real estate is situated.

Real estate tax is generally payable by the registered owner of the land or buildings. In certain cases, the user or the lessee is the payer. The taxable period is the calendar year. Taxpayers must file the tax return with the Financial Office by 31 January of the taxable period. It does not need to be filed in subsequent years, unless there is a qualifying change in the taxpayer or the character or size of the property. The tax is generally payable in two equal instalments during the year for which the tax is assessed.

Land tax

Land tax is generally levied on land that is located in the Czech Republic and registered in the Real Estate Cadastre. There are certain exemptions from land tax, such as plots of land owned by the State or used by accredited diplomatic representatives in the Czech Republic, plots of land owned by public universities, provided that they are not used for business activity or rented out. Some of the exemptions have to be claimed in the tax return.

The standard tax rate for construction sites is multiplied by a coefficient according to the size of the municipality in which the land is located. For Prague, the coefficient is 5. For other locations, the coefficient is between 1 and 3.5. Municipalities are allowed to increase or decrease (within certain limits) the coefficient for certain parts of the municipality by public ordinance. The coefficient for Prague can be increased to 5 at maximum.

Building tax

Building tax is generally applied to structures for which an approval for use is issued and which are located in the Czech Republic. The real estate tax is also levied on flats and non-residential premises individually registered in the Real Estate Cadastre.

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Real Estate Tax Summary

General

A foreign company can invest directly in real estate in Denmark, or through a public or private limited company, which is resident in Denmark.

Foreign companies or individuals who do not reside in Denmark, and who have not previously resided in Denmark for an aggregate period of five years prior to the date of acquisition, can only acquire real estate in Denmark through permission from the Minister of Justice. EU citizens and EU companies, established in accordance with legislation in a Member State may, under certain conditions, acquire real estate in Denmark without permission from the Minister of Justice.

Special rules apply with respect to holiday houses.

Please note that in August 2020, the Danish Government has suggested to introduce mark-to-market taxation of investment properties. However, no specific details have been presented yet.

Rental income/taxable income

Public and private limited companies resident in Denmark are taxed at the rate of 22% of their taxable income.

Companies may deduct interest expenses on loans and other expenses from their taxable income, however, subject to thin capitalisation rules as well as rules limiting the deductibility for net financing expenses.

Thin capitalisation rules apply when the total debt-to-equity ratio exceeds 4:1. The rules may limit the deductibility of interest expenses, capital losses and foreign exchange losses on loans from related parties or from third parties, if secured by a related party, provided the loans have not been obtained at full market conditions. Interest should not be subject to thin capitalisation limitations if it can be substantiated that loans have been obtained on market conditions (the company has the burden of proof, which is heavy and generally only substantiated by means of a binding loan offer from a bank).

In addition to the thin capitalisation rules, net financing expenses (ie, interest income and expenses and capital gains and losses on claims, debt and financial contracts, etc, but not including rental income) are only deductible to the extent they do not exceed 2.5% (for 2020) of the tax value of qualifying assets. Further, net financing expenses can only reduce EBITDA by 30%. Net financing expenses of 22.3 million Danish kroner (DKK) may, however, always be deducted under the 30% EBITDA rule.

Due to the fact that real estate companies usually have rental income and financing expenses, debt financing should be carefully considered. In principle, interest expenses corresponding to the 2.5% of the tax value of the building may only be deductible.

Certain expenses in connection with the acquisition of real estate and improvements must be added to the purchase price of the real estate or to the value of the shares in case of acquiring a Danish real estate company.

Tax consolidation

Joint taxation is mandatory for all Danish companies and Danish branches of foreign companies, including real estate, which are part of the group. The definition of a group corresponds to the definition of a group for accounting purposes. Under the joint taxation scheme, losses realised by one company can be offset against profits realised by another company.

Foreign group-related companies may effectively under certain circumstances also be included in a joint taxation group. If so, all foreign group-related companies must be included in the joint taxation and the consolidation must be in place for at least ten years. Rather complex rules apply in relation to taxation of recapture of foreign losses in connection with either a termination of an existing tax consolidation (ie, due to a takeover), or the election of such tax consolidation.

Withholding taxes

Interest on intra-group borrowings may be subject to interest withholding tax (WHT) of 22%. In principle, interest WHT should not be levied if the lender is a company covered by the EU Interest and Royalties Directive or is entitled to relief under a double taxation treaty (DTT) with Denmark. However, it is a requirement that the recipient is the beneficial owner of the interest.

Dividends on shareholdings of less than 10% of the share capital are subject to Danish WHT of 27% (may be reduced upon reclaim under an applicable DTT or if an agreement of exchange of information is in place between Denmark and a relevant country. For corporate investors, it is in general always possible to have the WHT reduced to 22% by reclaim irrespective of a DTT being applicable). Dividends would not be subject to Danish WHT, provided the recipient is a corporate investor that holds 10% or more of the share capital and is resident within the EU or a state with which Denmark has a DTT according to which the WHT should be reduced or waived. However, it is a requirement that the recipient is the beneficial owner of the dividend.

On 26 February 2019, the Court of Justice of the European Union (CJEU) issued its judgments in a number of cases regarding beneficial ownership both in regards to dividend and interest payments. Beneficial ownership is a condition for obtaining the WHT exemption on both interest and dividend according to the EU Parent-Subsidiary Directive and the EU Interest and Royalty Directive.

The underlying question of the cases was whether dividend and interest payments were exempt from withholding tax, when the payments were made from a Danish company to a company resident within the EU if the payments were fully or partially passed on to an ultimate parent company resident in a third country.

The Danish companies were all owned by a parent company resident in another EU Member State (Luxembourg, Cyprus or Sweden). The EU parent companies were all directly or indirectly owned by companies resident in third countries (eg, Bermuda or the Cayman Islands) or by private equity funds with unknown residency of the investors.

The Danish companies paid out either dividends or interest to their EU resident parent companies and claimed that such payments of dividend or interest was free of WHT in accordance with the EU Parent-Subsidiary Directive or the EU Interest and Royalty Directive.

In the CJEU judgement, The CJEU provided guidance on when an arrangement constitutes abuse of rights. If the funds are passed on wholly or partially shortly after they are received, this may serve as an indication that the entity is a flow-through or conduit and this could be an indicator of abuse. It is not a requirement that there is a contractual obligation to pass on the payment. Further, an indication for abuse may be if the recipient lacks substance or has been interposed in a structure that otherwise would not be covered by the EU Interest and Royalty Directive or the EU Parent-Subsidiary Directive.

In light of the significant uncertainty of the Danish tax consequences of interest payments and dividend distributions to foreign related parties, we recommend that a Danish tax advisor is contacted before distributions are made or a financing structure is set up and potentially that a binding ruling is obtained.

Danish general anti-abuse rule

Danish tax law contains a general anti-abuse rule (GAAR), which is based on mandatory provisions in the EU Parent-Subsidiary Directive.

Based on this provision, a taxpayer cannot benefit from the EU directives (ie, WHT may be payable on interest and dividends), if the relevant “arrangement” have been introduced with the main purpose to obtain a tax benefit that is not in line with the purpose of the directive. If there on the other hand are business reasons for the “arrangement” and the “arrangement” reflects the economic reality, the treaty and directive override provision will not be applicable.

According to the preparatory work, it is for the Danish Tax Agency to make an objective analysis of all relevant facts and circumstances when assessing whether an event or a series of events may constitute an avoidance, ie, works against the contents or purpose of the directive. It will be up to the Danish Tax Agency to determine whether there is an arrangement with the main purpose or one of the purposes to obtain a tax advantage that acts against the contents or the purpose of the directive.

The preparatory works does only give very little guidance regarding the exact context of the new provision, but the examples mentioned in the preparatory works are primarily situations involving non-tax treaty partner countries.

Hybrid mismatch rules (ATAD II)

Like other EU Members States, Denmark was required to introduce legislation to deal with hybrid mismatches per 1 January 2020. Anti-reverse hybrid rules must be implemented by 1 January 2022.

The Danish rules reflect the new hybrid concept as laid down by the ATAD II Directive, covering the situations where a Danish entity is the payor and a payment made results in a deduction with no inclusion “D/NI” or a double deduction “DD” with no dual inclusion income.

Also, rules are implemented in case such event occurs on a related payment that is not in scope of Danish tax and such event is not neutralised by one of the entities directly involved in that payment (“imported mismatch”).

The D/NI or DD issue must be triggered either between “related entities” or in a “structured arrangement” as defined in the provisions.

As a primary rule, the Danish entity (ie, payor) will be denied a deduction to neutralise the hybrid mismatch outcome. The secondary rule will be an inclusion of the received payment at the level of the payee if a deduction has not been denied at the level of the payor to neutralise the hybrid mismatch outcome.

Depreciation

Certain specifically defined buildings that are used for commercial purposes can be depreciated for tax purposes. Land cannot be depreciated.

Depreciations are made on the basis of the purchase price, ie, according to the straight-line method.

The purchase price must be allocated between land, buildings, installations, machinery and equipment.

The depreciation rate for buildings and installations is 4% a year with effect from the year of purchase. A higher rate may apply if the physical lifetime is 25 years or less.

Machinery and equipment, furniture and fixtures are depreciated on a pool basis, with up to 25% on a declining balance.

Property tax

Real estate taxes are divided into a municipal land tax and a municipal real estate tax on buildings.

For municipal land tax, tax rates vary between 1.6% and 3.4% on the value of the land depending on the municipality in question. For the Copenhagen area the tax rate is 3.4%. The basis for the tax is the value of the land, which generally is less than 50% of the value of the real estate (ie, building and land). Further, a tax ceiling principle applies, which means that often the 3.4% land tax is calculated based on a value lower than the latest public assessment.

Municipal real estate tax on buildings used for business purposes is 0.98% in Copenhagen, but lower in most other municipalities This tax is calculated based on the value of the building (ie, property value minus a basic allowance of 50,000 DKK (approximately 6,700 EUR), and minus the value of the land).

Significant changes are expected following a real estate tax reform in Denmark, which will be implemented in stages from 2020 until 2024. The reform is expected to imply that the tax values of Danish properties (especially in Copenhagen and other major cities/prime locations) will increase significantly. However, politically it has been stated that it is not the intention to increase the tax revenue at total country level, why it is expected that the applicable rates will be decreased accordingly (for example, the land tax rate in Copenhagen is currently 3.4% but is expected to be decreased to 1.26% in 2024, when the reform is fully implemented).

We recommend consulting Danish advisors with respect to the new developments and implementation of the real estate tax reform.

Capital gains on the sale of property

Companies subject to full Danish tax liability and branches are taxed with 22% on gains from the sale of Danish real estate. The purchase and sales prices are converted to cash values.

The profit is the difference between the sale price and the adjusted acquisition price. In principle, the acquisition price is adjusted by 10,000 DKK per year as a fixed amount. Improvements exceeding 10,000 DKK may also be added.

Any tax depreciations will be recaptured in connection with the sale of buildings. Capital losses realised on the sale of property can only be offset against taxable profit on properties in the year of disposal, or in the following income years.

If the company is engaged in buying and selling real estate as its trade, the profit is fully taxable, regardless of the period of ownership and no adjustments are allowed. Recaptured depreciation is also taxed. In brief, taxable profit

is computed as the sales price, minus the acquisition price, which has been reduced by tax depreciation. No conversion to cash value is made. Losses are tax deductible and can be carried forward without limitations.

Capital gains on the sale of shares

Foreign corporate shareholders of Danish real estate companies are not subject to tax in Denmark on capital gains from the sale of shares.

Danish corporate shareholders holding shares not listed on a recognised stock exchange are not subject to Danish tax on capital gains from the sale of the shares, and losses are not deductible.

Listed portfolio shares (less than 10% ownership) are taxed on a mark-to-market basis, ie, on an unrealised basis.

Loss carryforward

Any operating losses may be carried forward and offset positive income of the company itself or income of entities that were members of the joint taxation during the period the losses derive from. Change of ownership may restrict the possibility to carry forward losses.

Losses carried forward may not reduce the taxable income by more than 60%. A “safe harbour” of approximately 8.57 million DKK (for 2020) losses carried forward may always offset taxable income.

Real estate stamp duty

In connection with the sale of real estate, a deed is subject to a stamp duty of 0.6% of the purchase sum, or at least of the rateable cash value of the property. In addition, a registration fee of 1,750 DKK is charged.

Mortgage loans obtained to finance real estate are subject to a stamp duty of 1.45% subject to planning around stamp duty on existing mortgages and an additional registration fee of 1,750 DKK is charged.

Value-added tax (VAT)

In principle, the sale of Danish real estate would not trigger Danish VAT. However, as of 1 January 2011 the first sale of newly built real estate (ie, buildings where construction has commenced after 1 January 2011) is subject to Danish VAT. Further, sale of real estate that has been substantially rebuilt (more than 25% of the value of the real estate) is subject to Danish VAT.

We recommend consulting Danish advisors with respect to any VAT issues in relation to acquisition or sale of Danish real estate.

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Estonia

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

General

Foreign investors from EEA or OECD member countries may generally invest in Estonian real property without any legal restrictions and do so either directly or via a local entity, eg, a private limited company (*osaühing*, or OÜ), or a public limited company (*aktsiaselts*, or AS). A foreign legal entity may also register a branch (*Eesti filiaal*) in the Estonian commercial register. Foreign investors frequently invest in Estonian property through either a resident or a non-resident holding company structure, eg, a holding company owning shares in one or more subsidiary companies.

Certain legal restrictions apply to legal entities from EEA or OECD member countries acquiring agricultural land and woodland covering an area of ten hectares or more. Foreign individuals and companies not resident in the EEA or in any OECD member state cannot acquire land without the permission of a local authority. In addition, certain legal restrictions apply to acquiring land by non-EEA foreign individuals and legal entities in smaller islands of Estonia, as well as in listed territories adjacent to the frontier with Russia.

Corporate income tax

Estonia is regarded as offering a relatively favourable income tax regime, where all undistributed corporate profits are tax-exempt. This exemption also covers profits derived from renting out property and capital gains from the sale of property. The moment of taxation of corporate profits is postponed until the profits are distributed as dividends, share buy-backs, capital reductions, liquidation proceeds, or deemed profit distributions. Distributed profits are generally subject to 20% corporate income tax (20/80 on the net amount of profit distribution). Starting from 2019, a lower corporate income tax of 14% is made available for companies making regular profit distributions. The payment of dividends in the amount that is below or equal to the extent of taxed dividends paid during the three preceding years (20%) will be taxed with a rate of 14% (the tax rate on the net amount being 14/86 instead of the regular 20/80). 2018 is the first year to be taken into account for the purposes of determining the average dividend payment.

From the Estonian perspective, this tax is considered as a corporate income tax and not a withholding tax, so the tax rate is not effected by the existence of a double tax treaty. The above tax regime is available to Estonian companies and permanent establishments (PEs) of foreign companies that are registered in Estonia. In Estonia, resident companies are taxed on profits distributed from their worldwide income, while PEs of non-residents are taxed only on profits distributed from income derived from Estonian sources. Other Estonian-source income derived by non-residents may be subject to final withholding tax or corporate income tax by way of assessment.

Rental income

Rental income derived by foreign taxpayers is generally taxed on a gross basis, mainly through withholding at source.

Depreciation and loss carryforward

There is no adjustment of accounting profits for tax purposes; distributable profits are determined, based on financial statements drawn up in accordance with Estonian GAAP or IAS/IFRS.

Financing the property

Interest expense on loans taken to finance real property acquisition is generally fully deductible. Currently, Estonian tax law does not include thin capitalisation rules. However, as of 2019 corporate income tax is levied on the exceeding borrowing costs which exceed: 1) 3,000,000 EUR; 2) 30% of the taxpayer's EBITDA and 3) the losses of the taxpayer, unless an exemption applies.

Withholding taxes

A number of different withholding taxes may apply to the payments of taxable Estonian source income to non-residents. Payments subject to withholding tax include the following:

Dividends

In general, there is no withholding tax on dividend distributions to any non-resident corporate or individual shareholders.

From 2019 and onwards, in cases where the recipient of the 14% dividend is either a resident or non-resident individual, a 7% withholding tax will apply unless a tax treaty provides for a lower withholding tax rate (5% or 0%).

Interest

In general, there is no withholding tax on “arm’s length” interest payments to non-residents.

Interest payments to non-residents are taxed only in case the interest is received in connection with a holding in a contractual investment fund or other pool of assets of which assets, at the time of the payment of interest or during a period within two years prior to that, more than 50% was directly or indirectly made up of immovables or structures as movables located in Estonia and in which the non-resident had at least a 10% holding at the time of receipt of interest. Income tax is not charged on interest if the income of the investment fund constituting the basis thereof has been taxed or is tax exempt if certain conditions are met.

Royalties

Royalties (including payments for the use of industrial, commercial or scientific equipment) paid to non-residents are generally subject to 10% withholding tax under domestic law, but reduced rates may be available under double tax treaties. Certain royalty payments to associated EU and Swiss companies that meet certain conditions are exempt from withholding tax.

Rental payments

Rental payments to non-residents for the use of real property located in Estonia and movable property subject to registration in Estonia (excluding payments for the use of industrial, commercial or scientific equipment) are subject to 20% withholding tax under domestic law, but double tax treaties may exempt payments for the use of movable property from withholding tax.

Service fees

Payments to non-resident companies for services provided in Estonia, including management and consultancy fees, are subject to 10% withholding tax under domestic law, but exemptions may be available under double tax treaties. Service fee payments to tax haven entities are always subject to 20% withholding tax.

Tax reporting

For non-residents who do not have a PE in Estonia, the tax withheld from the above payments at domestic or treaty rates constitutes final tax as regards their Estonian source income and the non-resident is generally not liable to submit a tax return to the Estonian tax authorities for income so taxed.

Estonia has effective tax treaties with Albania, Armenia, Azerbaijan, Austria, Bahrain, Belarus, Belgium, Bulgaria, Canada, the People’s Republic of China, Croatia, the Czech Republic, Cyprus, Denmark, Finland, France, Germany, Georgia, Greece, Hong Kong SAR, Hungary, Iceland, India, the Isle of Man, Israel, the Republic of Ireland, Italy, Japan, Jersey, Kazakhstan, the Republic of Korea, Kyrgyzstan, Latvia, Lithuania, Luxembourg, Macedonia, Malta, Mexico, Moldova, the Netherlands, Norway, Poland, Portugal, Romania, Serbia, Singapore, Slovakia, Slovenia, Spain, Sweden, Switzerland, Thailand, Turkey, Turkmenistan, Ukraine, the United Arab Emirates, the United Kingdom, the United States of America, Uzbekistan and Vietnam. Treaties have also been concluded with Russia, Guernsey and Morocco; however, these are not effective yet.

Capital gains

Capital gains from the sale of property derived by Estonian companies and PEs of foreign companies that are registered in Estonia are exempt from corporate income tax until distribution of profits.

For non-residents, certain capital gains realised from certain assets linked with Estonia are subject to 20% income tax. Such assets include real property located in Estonia and shares in Estonian companies that derive a significant part of their value directly or indirectly from real property located in Estonia.

For certain types of Estonian source income, non-residents are liable under Estonian domestic law to self-assess Estonian tax and submit a tax return to the Estonian tax authorities. Such types of income include:

- taxable capital gains;
- profits derived from business conducted in Estonia without a registered PE;
- other items of income from which income tax was not withheld but should have been withheld.

Land tax and property taxes

Land is subject to annual land tax that is calculated on the assessed value of land at rates between 0.1% and 2.5%, depending on municipality. The rate of land tax for areas under cultivation and for natural grasslands is between 0.1% and 2%. The tax is paid by the owners of land, or sometimes by the users of land, generally in two instalments by 31 March and 1 October (amounts not exceeding 64 EUR are paid in one instalment by 31 March). The land under home is generally exempted from land tax. There is no separate net wealth or property tax.

Local taxes

Local taxes can be imposed by rural municipalities or city councils. The fiscal significance of local taxes is almost non-existent. Currently, local taxes include advertisement tax, road and street closure tax, motor vehicle tax, tax on keeping animals, entertainment tax and parking charges.

Transfer taxes

There are no transfer taxes or stamp duties in Estonia, but state fees and notary fees are usually due upon transferring real estate (which require entries to the register of immovables).

The rates of notary and state fees depend on the types of transaction and the value of property and are calculated based on affixed schedule established in the Notary Fees Act and the State Fees Act. Please find below three indicative numerical examples[1] for the disposal of property with transaction values of 100,000 EUR, 1,000,000 EUR and 10,000,000 EUR:

- 100,000 EUR – the state fee of ca 110 EUR and the notary fee of ca 320 EUR;
- 1,000,000 EUR – the state fee of ca 1,600 EUR and the notary fee of ca 2,928 EUR;
- 10,000,000 EUR - the state fee is capped at 2,560 EUR and the notary fee of ca 12,180 EUR.

However, notary fees are calculated case by case and the exact notary fee costs for the transactions can only be calculated by the notary based on the specific terms of contract concluded between the parties.

Value-added tax (VAT)

The standard VAT rate is 20% and the reduced rate is 9%. The VAT rate on the export of goods and certain services as well as intra-Community supplies is 0% (exemption with credit). Transactions with immovable property are generally exempt from VAT (exemption without credit) but there exist certain significant exceptions (eg, transactions with new and significantly renovated buildings, building land, as well as unfinished buildings). Taxpayers can opt to tax real estate transactions with VAT if certain conditions are met, but this does not apply to transactions with residential property.

VAT can be fully deducted upon the acquisition of immovable property if the buyer is registered for VAT in Estonia and uses the assets exclusively for making taxable supplies subject to VAT. Adjustment of the deducted input VAT must be made during a ten-year period if the immovable asset is sold (without opting for taxation of the transaction)

[1] Indicative numerical examples are without VAT

or is no longer used for making taxable supplies subject to VAT. The adjustment also applies to the input VAT incurred for the improvement of the asset. Foreign businesses cannot recover input VAT incurred upon acquiring Estonian immovable property under the cross-border VAT-refund procedure.

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Real Estate Going Global

Finland

Tax and legal aspects of real estate investments around the globe

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Real Estate Tax Summary

General

A foreign investor may invest in Finnish real estate property through a local company, such as an *osakeyhtiö* (Oy), a local partnership, such as a *kommandiittiyhtiö* (Ky), or a non-resident company, partnership or other legal entity. There are no exchange controls and no special investment laws governing foreign investments.

Rental income

The standard corporate income tax rate in Finland is 20% (year 2020). In computing the tax liability in respect of rental income, deductions will generally be available in respect of items such as depreciation, maintenance, management and administration, interest costs and real estate tax.

Finnish real estate property is often held by a Finnish mutual real estate company (MREC). An MREC is a limited liability company, the shares of which are attributable to certain parts of the real estate property, and the shareholder of the MREC holds/controls the respective parts of the real estate property through the shares (special provisions in the MREC's articles of association are included in this respect). In case of an MREC, rental income will arise to the shareholder of the MREC, whereas in case of a regular real estate company, rental income will arise to the real estate company.

Ordinary real estate companies (OREC) operate like normal limited liability companies. Rental income is received by the OREC and it will be taxable in Finland at a current rate of 20%. When the premises are leased, it is the OREC who acts as the lessor. The profits are distributed to the shareholder as dividends.

Interest deduction limitation rules

As a starting point, Finnish companies are allowed to deduct interest expenses on both external and related party loans provided that both the amount of debt and the rate of interest are at "arm's length" and that the interest cost relates to the business operations of the Finnish entity.

This being said, interest deductibility limitation rules that implemented ATAD 1 entered into force as of 1 January 2019. The new rules are applied for the first time in the taxation for financial year 2019. Broadly, the deductibility of a company's net financing expenses in Finland are limited to 25% of the company's adjusted taxable income (EBITD) and is applied at the level of an individual company.

In case the total net financing expenses (including both internal and external financing) exceed 500,000 EUR, the interest deduction limitations will apply. Should the total net financing expenses exceed the threshold of 500,000 EUR, the deductible net financing expenses are limited to 25% of the company's adjusted taxable income (EBITD, ie, taxable income including group contributions and adding back interest expenses and tax depreciation). Thus, in this case, the amount that exceeds 25% of the company's EBITD is non-tax deductible. However, external net financing expenses are always fully deductible up to 3 million EUR and will be deducted before internal financing expenses. This means that in case the net external financing expenses already exceed 25% of the company's EBITD, any of the internal financing expenses cannot be deducted.

Depreciation

Tax depreciation is limited to the cumulative charges made in the books. Acquisition costs of land may not be depreciated. Acquisition costs of buildings and other constructions are depreciated using the declining balance method, the maximum rates being, eg,

- 4% for residential buildings, office buildings or other similar buildings;
- 7% for retail buildings, warehouses, factories, workshops, power stations or similar buildings;
- 20% for buildings or constructions used exclusively for research and development; and
- 25% for machinery and equipment.

Accelerated depreciations for tax years 2020-2023

The law on accelerated depreciation on machinery and equipment for tax years 2020-2023 entered into force on 1 January 2020.

Under the new legislation, a taxable person engaged in agriculture or a business may annually deduct up to 50% instead of 25% of the tax carrying value of newly acquired machinery or equipment in tax years 2020-2023.

The accelerated depreciation represents a temporary difference and must be recorded in the depreciation difference calculation in the statutory financial statements.

In order to have accelerated depreciation on investments in machinery and equipment the following conditions must be met:

- The machinery or equipment is new, ie, it has not been purchased second-hand.
- The machinery or equipment was taken into use on or after 1 January 2020.
- The machinery or equipment is used by the taxable person for the purposes of his business or agricultural activity.
- The machinery or equipment belongs to the movable fixed assets of the company or to the fixed assets of agriculture.

Accelerated depreciation in taxation requires that a corresponding depreciation has been recorded as an expense in the statutory financial statements.

Real Estate Investments

Real estate tax

In Finland, there is a separate municipal tax on real estate property. The most significant exemptions concern forests and agricultural land. The tax is payable by the owner of the taxable property at the beginning of the calendar year, even if the owner is a non-resident investor.

The tax rate is based on the taxable value of each individual real estate property. The general tax rate may vary between 0.93% and 2% (year 2020). For permanent residences, the tax rate may vary between 0.41% and 1% (year 2020). Municipalities decide annually, within agreed limits, what percentage will be used in their particular municipality.

In real estate taxation, the municipality may impose a separate real estate tax on a vacant plot, if the plot is situated on a town plan area and it is not in residential use or under construction. The tax rate on vacant plot may vary between 2% and 6% (year 2020).

Real estate tax is deductible for corporate income tax purposes, provided that the property has been used for rental or business purposes.

Withholding taxes on interest payments and dividend distributions

Finland does not levy interest withholding tax under its domestic tax law from non-resident recipient (as far as the instrument on which the interest is paid on cannot be re-qualified as equity).

The general Finnish domestic withholding tax rate on dividends is 20% for non-resident corporations and 30% for non-resident individuals.

However, based on the EU Parent Subsidiary Directive, which has been incorporated into the Finnish domestic tax law, the Finnish dividend withholding tax rate is reduced to 0% in respect of dividend distributions to a qualifying EU resident company that owns 10% or more in the capital of the distributing Finnish company. There is no holding period requirement for the application of the reduced rate of 0%.

In addition, a non-resident company receiving dividends from Finland should not suffer withholding tax in Finland if the same dividend distributed to a comparable Finnish resident entity would be tax-exempt given that certain conditions are met (recipient is resident in EEA member state, Finland has agreed on mutual assistance and information exchange in direct taxation matters with the resident country, and Finnish withholding tax is not fully credited in recipients' resident country).

Dividends from a listed company received by a non-listed company are subject to withholding tax of 20% if the company owns less than 10% of the share capital of the distributing company. Also, dividends received by non-resident recipient which is a financial, insurance, or pension institution are subject to withholding tax of 20% if the shares belong to investment assets, unless the receiving company is a company mentioned in the EU Parent Subsidiary Directive that owns 10% or more in the capital of the distributing Finnish company.

A reduced dividend withholding tax rate may apply under a tax treaty concluded by Finland.

Consolidation of profits and losses

Finnish tax law uses the concept of group contributions instead of tax consolidation to offset the losses and profits in a group of companies. Previously, most real estate companies were generally not entitled to the group contributions' system since real estate companies were typically taxed in the basket of other income. However, due to the reform of income baskets applicable to limited liability companies, the group contribution regime, became available to all companies that are taxed in accordance with the Business Income Tax Act as of 1 January 2020, ie, typically ORECs and Finnish holding companies. The group contribution regime is still not available for MRECs.

A group contribution is a deductible cost for the granting company and taxable income for the receiving company, provided that all of the following are true:

- Both companies belong to a group where there is a direct or indirect common ownership of at least 90%, and the group structure has existed for the entire fiscal year.
- Both companies are Finnish resident for tax purposes.

- Both companies are limited liability companies or co-operatives with business activities (ie, are taxed in the basket of business income in accordance with the Business Income Tax Act) and are not financial, insurance, or pension institutions.
- The contribution is recorded in the annual statutory accounts of both companies involved and must affect their annual net income.
- The accounting period for both companies ends at the same date.
- The amount of contribution does not exceed the taxable business income of the granting company.
- The contribution is not considered a capital investment.

Based on case law, the ownership chain may also be traced via foreign entities, provided there is a tax treaty between Finland and the country wherein the ultimate parent for the group is resident.

Capital gains

Capital gain realised on the sale of Finnish real estate property is taxable income for a Finnish resident vendor. Similarly, capital gain realised on the sale of shares in a Finnish real estate company is generally taxable income for a Finnish resident vendor.

In accordance with the domestic tax law, non-Finnish resident taxpayers are subject to tax on Finnish source income. Such income includes, eg, capital gain realised on a transfer of Finnish real property or shares in a Finnish housing company or other company, of which more than 50% of the assets comprise real estate property. An applicable tax treaty may limit Finland's taxing right on capital gains realised by non-Finnish residents.

Loss carryforward

In principle, ordinary tax losses from business activities can be carried forward for ten years. Tax loss carry forwards are forfeited in case of a direct or indirect change in the ownership of the company. However, an exemption order may be applied from the Finnish tax authorities to retain the losses. Capital losses in respect of non-business assets can only be deducted from capital gains related to such assets in the same fiscal year, or in any of the following five years.

Transfer tax

The transfer of real estate located in Finland and the transfer of shares in a Finnish company is generally subject to transfer tax payable by the purchaser. Also transfer of shares in a foreign company owning directly or indirectly Finnish real property may be subject to Finnish transfer tax.

A transfer of a real estate is subject to a transfer tax of 4%, and a transfer of shares in real estate companies is subject to transfer tax of 2% (under certain conditions transfer tax may not be due on the transfer of shares in a Finnish company if neither the seller nor the purchaser are Finnish tax residents or Finnish branches of financial institutions). The transfer tax base includes the purchase price as well as any payment made by the purchaser that is a prerequisite for the transfer, or any liability that the purchaser assumes where the seller benefits from the arrangement. In addition, the transfer tax base may include certain other debts of the company being transferred.

Determination of transfer tax base is complex and requires case-by-case analysis of the facts and circumstances. There are also several cases pending in the courts regarding determination of the transfer tax base.

Value-added tax (VAT)

The standard VAT rate currently stands at 24% (year 2020). In Finland, it is optional for a real estate owner to apply for VAT liability for collecting rents. The option is available if the end-user uses the premises for VAT taxable purposes or is eg, a university, university of applied sciences, approved provider of professional education, government body or municipality insofar as the municipality is entitled to VAT deductions or is a subject to a special VAT recovery. Letting out of residential premises is VAT exempt. The supply of shares of a real estate company or a mutual real estate company is not subject to VAT. The supply of immovable property is also not subject to VAT in Finland.

The definition of a real estate from a VAT point of view has changed as of 1 January 2017. The definition of a real estate is determined based on the Council Implementing Regulation (EU) No 1042/2013. The Regulation also includes an example list of transactions identified as services connected with real estate. Services that are

considered to relate to real estate are subject to VAT in the country where the real estate is located, ie, the general EU reverse charge rule is not applicable.

The new definition has widened the scope of real estate. Thus, also the scope of real estate investment subject to VAT adjustment right and liability is wider which should be considered when making the adjustment liability calculations.

The right to deduct input VAT on cost related to disposal of shares has historically been challenged by the Finnish Tax Authority. However, as an exception to the above, based on the case law, input VAT on transaction costs is considered as an overhead costs of the seller and, thus, potentially partly deductible, if the sale of shares/real estate meets the requirements of business transfer (the whole business or separate part of the business, eg, a portfolio of real estate companies in one area) or it is considered as cessation of trading (business or part of it). According to recent case law, transaction costs concerning exists made by real estate investors carrying out rental business should be accepted as overhead costs, if the costs are not included in the price of the shares. If the rental business is wholly or partly VAT taxable, the VAT of transaction costs should be recoverable for the corresponding part.

Letting of real estate

According to the main rule, letting of real estate is not subject to VAT. Therefore, input VAT is not recoverable.

Applying for voluntary VAT registration for the lease of immovable property and, as a result, recovery of input VAT is possible. However, voluntary VAT liability is subject to special rules and can be applied only under certain circumstances.

Adjustment rules

VAT deduction in relation to the new-building and large refurbishment (real estate investment) are subject to adjustment, if the real estate (building, land, permanent construction or a part thereof) is sold or transferred from VAT deductible use to a use which does not entitle to VAT deductions or vice versa.

The adjustment time for negative and positive VAT deduction adjustments is ten years. Every year the actual VAT deductible use is compared to the original use. Every year 1/10 of the VAT is subject to adjustment consideration. The adjustment liability decreases 10% of the original amount each year.

Reverse charge (VAT) in the construction sector

The aim of the domestic reverse charge system is to reduce the potential tax risk associated with VAT fraud. There are two prerequisites that need to actualise for the reverse charge to apply. The reverse charge mechanism will apply

1. when construction work is performed in Finland or when people are contracted by a Finnish business to perform construction work; and
2. when the buyer is a business selling construction services on an ongoing basis.

The reverse charge mechanism applies to eg, construction services such as excavation and foundation work, construction work, installation work, finishing work, on-site cleaning and supplying contracted employees to a site. It is noteworthy that the scope of services to which the reverse mechanism applies is still relatively unclear, so it is advisable to check each service separately before invoicing it.

In situations where the reverse charge applies and the buyer is VAT liable, the seller is required to issue an invoice. It is the seller’s obligation to establish whether the buyer meets the requirements for the reverse charge system outlined above. If both the services in question and the status of the purchaser meet the requirements, it is mandatory to invoice the services without VAT using the reverse charge mechanism. The supplies and purchases as well as the Finnish VAT calculated by the buyer are reported separately in the VAT return form.

Upcoming changes in tax legislation

The Finnish Ministry of Finance is planning a reform to the determination of tax values for real estate tax purposes. It is expected that the reform would be introduced as of 2022.

The Finnish Ministry of Finance has introduced in June 2022 a working group to investigate if it would be possible to (i) enact a 5% withholding tax for certain entities exempted from dividend withholding tax (such as Finnish and foreign investment funds and Finnish non-profit organisations) and (ii) enact a “reasonable tax” for real estate

income received by foreign investment funds and other tax exempt parties. The working group is expected to give their recommendations in Spring 2021.

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Real Estate Going Global

France

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

A foreign corporate investor may invest in French property directly or through a local, eg, a *société à responsabilité limitée* (SARL), a *société anonyme* (SA) or a *société par actions simplifée* (SAS), or non-resident company, or through a partnership such as a *société civile immobilière* (SCI).

Foreign investors frequently invest in French real estate assets through a two-tier structure, in which a French company owns the real estate asset, with the shares of the French entity being held by a foreign holding company (eg, Luxembourg or Belgian holding company). This type of structure is frequently used for the acquisition/holding of French property since the sale of the shares in such a foreign holding company (or even the shares in the French company) may fall outside the scope of French capital gains taxation.

Rental income

The standard rate

The standard rate of corporate income tax (CIT) is 28% (for the companies whose turnover exceeds 250,000,000 EUR, applicable CIT rate is 31% for the portion of the taxable income exceeding 500,000 EUR). This rate will progressively be reduced to 25% by 2022, as follows:

- in 2021: all profits will be subject to CIT at the rate of 26.5% (except for the companies whose turnover exceeds 250,000,000 EUR where the applicable CIT rate will be 27.5%); and
- in 2022: all profits will be subject to CIT at the rate of 25%.

Social surcharge

Companies with an annual turnover of at least 7,630,000 EUR and whose CIT liability (standard rate and the reduced rate) exceeds 763,000 EUR are subject to a social surcharge of 3.3% levied on the part of the corporate tax which exceeds 763,000 EUR.

Thus, the resulting effective rate should be: 28.92% (or 32.02% for the companies whose turnover exceeds 250,000,000 EUR for the portion of the taxable income exceeding 500,000 EUR) in 2020, 27.37% (or 28.41% for the companies whose turnover exceeds 250,000,000 EUR) in 2021, and 25.83% in 2022.

Non-resident companies

Local and non-resident companies and partnerships owning French property are allowed to deduct interest expenses (on loans borrowed from third parties and banks or sister companies) and property-related costs from their taxable income.

Local and non-resident companies are also allowed to deduct the majority of other types of business costs including acquisition costs. Certain expenses, such as architect's fees and refurbishment costs incurred during construction, cannot be deducted when incurred and must be added back to the acquisition price of the property.

There is no withholding tax (WHT) on tax-deductible interest on loans in France when properly documented.

Interest rate limitation

The interest rate levied on a loan granted by a related party should not exceed the interest rate published by the French Tax Authorities (FTA) (ie, 1.32% for financial years closing on 31 December 2019) except where the company is in a position to evidence that the interest rate applied is considered as "arm's length" based on contemporary bank offer or a supporting transfer pricing documentation.

General limitation of net financial expenses/ATAD I

As of January 2019, according to Article 212 *bis* of the French Tax Code (FTC), the deductibility of the net financial expenses is limited to the highest of either 3,000,000 EUR or a 30% "tax EBITDA" of the company, reduced respectively to 1,000,000 EUR or a 10% in case where the company is thin-capitalised.

Specific deductibility limitation computation rules apply to tax consolidation.

Anti-hybrid rule/ATAD II

The French Finance Act for 2020 transposed into French law the rules arising from Directive EU/2017/952 of 29 May 2017 (ATAD II), focusing mainly on situations of double deduction and deduction without inclusion which would apply not only between EU Member States but also in situations involving third countries.

The new rules address situations in which, due to conflicting tax rules between two or more jurisdictions, a same payment is deducted twice for tax purposes, or is deducted in one jurisdiction without inclusion/taxation in the other. These rules do not address situations in which little or no tax has been paid due to a low tax rate or the favourable tax system of a jurisdiction. In presence of hybrid mismatch, tax deduction should be denied in France.

These new rules apply to financial years starting from 1 January 2020, with the exception of those relating to reverse hybrids, which will apply to financial years starting from 1 January 2022.

Depreciation

Each component of a property must be booked individually and depreciated accordingly, ie, facade, heating system, structures, interiors, etc.

For properties held by a look-through entity (such as an SCI, or a *société en nom collectif*, or SNC), the deductible depreciation charge can be limited by the amount of the net rental income generated by the property (difference between the rents and all the property-related costs, including interest), the excess being carried forward indefinitely.

It should also be noted that under certain circumstances, buildings are not treated as depreciable assets, but as inventory (eg, when owned by brokers or developers).

Capital gains on the sale of property

Subject to tax treaties, capital gains realised upon the sale of French properties and the sale of real estate shares by local and foreign companies are taxed at the standard CIT rate of 28% (28.92% in 2020, 27.37% in 2021, and 25.83% in 2022, including social surcharge of 3.3% where applicable).

However, capital gains realised upon the sale of listed real estate shares is taxed at the reduced corporate tax rate of 19% where the interest of at least 10% is held for at least two years (otherwise, standard CIT rate is applicable), plus social surcharge of 3.3% (where applicable).

In addition, foreign entities and bodies are subject to the 28% capital gain tax (26.5% in 2021, and 25% in 2022) on capital gains realised upon the sale of French properties or shares in companies whose assets mainly consist of French properties. The 19% WHT can apply when listed shares are sold. The 28% and 19% WHT can be offset against the corporate tax due on the capital gains (but not the social surcharge of 3.3%). If the amount of the WHT exceeds the CIT charge, the excess is then refundable.

The 3% annual tax

French or non-French entities with or without legal personality, including trusts and similar vehicles, owning either directly or indirectly (and whatever the number of companies interposed between the building and the ultimate shareholders) real estate properties located in France, which do not perform a professional activity other than a rental one, fall within the scope of a 3% property tax. This tax is levied annually and is based on the fair market value of French real estate property owned as at 1st January.

Under certain conditions, automatic exemptions (eg, sovereign states, entities where stocks are admitted to negotiation on a regulated market and are regularly and significantly traded, pension funds, non-listed open-ended real estate funds) and exemptions subject to filing requirements may apply.

Moreover, according to the FTA guidelines, entities filing 3% tax returns must, if requested, provide the FTA with supporting documentation in order to confirm the identity of its investors/stakeholders, their addresses and the number of units held. Such documentation includes (but is not limited to):

- corporate formation and governance documents filed with the courts or public services of the state or territory in which the entity resides, such as an extract from the Company Registry or Register of Commerce or equivalent, articles of association, corporate registration information imposed by the corporate law of the country concerned, shareholder minutes or other minutes of meetings of management bodies, minutes of general meetings, board of directors or supervisory board, etc;
- statements or information returns filed with the tax authorities of the state or territory of residence of the entity when they provide such information;
- documents authenticated by a member of a regulated profession recording the distribution of shares and movements of securities (registers of registered or movement securities), as well as any evidence relating to financial movements related to the sale or acquisitions of securities, capital increases or reductions;
- any other official document issued by a foreign administration or government specifying the identity and address of the shareholders or unit holders and the number of shares or rights held, including the shareholder's passport or identity card.

To provide the requested confirmation, a confirmation letter has to be prepared and signed by the General Partner/Manager. The FTA have retained the right to ask for additional documentation.

Withholding tax/dividends

Subject to tax treaty provisions, the 28% WHT (progressively reduced to 26.5% in 2021, and 25% in 2022) applies to branch profits that are deemed to be distributed to the shareholders of a foreign company having a French branch. However, this WHT is no longer applicable to companies located in EU countries and subject to CIT, or in position to demonstrate that the income of the branch was not disinvested from France.

Subject to tax treaty provisions, the 28% WHT is levied on dividends paid by a French company to its foreign shareholder. Pursuant to the EU Parent-Subsidiary Directive and under certain conditions (notably with respect to the substance and principal purpose test requirements), the WHT does not apply to dividends paid by a French entity to its foreign parent company residing in an EU country. By way of exception, the WHT is levied at the rate of 75% when the dividend is paid in a non-cooperative country.

Real estate transfer tax/Value-added tax (VAT)

The acquisition of the legal title to a property in France can be subject to real estate transfer tax at 5.80665% (or 5.09006% in a small part of French departments), or to real estate VAT at the rate of 20% and reduced real estate transfer taxes (subject to conditions), depending upon the characteristics and use of the property.

The purchase of shares in French or foreign real estate companies, unless listed, is subject to 5% transfer duty. The same rules apply to the disposal of shares in foreign companies whose assets predominantly comprise real estate assets and/or rights.

Surtax on real estate capital gains

A specific tax applies to real estate capital gains on sales of property, whether involving real estate assets or rights, when the taxable amount, determined after the application of the allowance for holding period, is greater than 50,000 EUR.

Taxes paid on sales of taxable assets (excluding, in particular, sales of main residences) are increased by between 2% (if the amount of the net capital gains exceeds 50,000 EUR) to 6% (if the amount of the capital gains exceeds 260,000 EUR). This surtax rate applies to the full amount of the taxable capital gains. Hence, the taxation rate, currently 19%, will be between 19% and 25%, depending on the amount of capital gains realised.

The surtax is due by individuals or tax transparent entities (companies or groups who are within the scope of Articles 8 to 8 ter of the FTC), and by taxpayers who are not French tax resident, but who are subject to the individual income tax.

SIIC (F-REIT) and OPCI

Favourable tax regimes applicable to specific real estate investment vehicles are developed in the following sections.

Real Estate Investments

General

Introduction

This guide comprises an overview of the tax and legal aspects relating to the acquisition of commercial real estate in France. It is not intended to be comprehensive and consequently should only be relied on as an introduction to general matters relating to French property law and tax.

We have excluded from this guide the specific rules relating to operators who buy and hold property as inventory with the intention of resale. Suffice it to say that those players can benefit from a favourable rate of transfer duties when they acquire property as inventory, provided that certain conditions are satisfied.

The tax aspects are considered with respect to investments made by corporate investors under the ultimate control of non-resident corporate investors. We have also included some key information on non-trading investments realised by individuals.

Foreign investment control

The general rule is that there is no restriction on the purchase and sale of real estate which constitutes a foreign direct investment in France. A declaration has to be filed with the French Treasury once the investment has been made (the investment is deemed made as soon as an agreement has been entered into). A statistical form (*compte rendu*) has to be filed with the French Central Bank (*Banque de France*) within a reasonably short period, following the purchase or sale of a direct investment in excess of 15 million EUR.

A foreign direct investment can take either of the following forms:

- the purchase, creation or extension of a business or branch;
- any other operation which constitutes the acquisition of, or the increase in, the control of a company carrying on an industrial, agricultural, commercial, financial or real estate activity, or which constitutes an extension of such a company's activity already controlled by the non-resident company or person.

Non-residents may freely incorporate a company in France. If the investment is in excess of 15 million EUR a statistical form must be filed with the French Central Bank (*Banque de France*) within a reasonably short period after the investment is made.

No formality is required to acquire a company that owns investment property or has a real estate activity. However, in the case of an investment in a company whose activity is to construct and sell on or rent out buildings, a declaration must be filed with the French Treasury. A statistical form must be filed on disposal of the investment.

Direct investments in French real estate

Legal aspects

Ownership

Ownership of a property is the right to enjoy and use of the property in the most absolute manner, provided the use is not prohibited by laws or regulations (freehold). Leasehold rights, which confer on the tenant a real estate interest, also exist but are quite rare. It is possible for the bare ownership (*nue propriété*) to vest with one owner and the usufruct (*usufruit*) that gives the right to possession or the income, to vest with a different owner. A "*nue propriété*" or "*usufruit*" right purchased by or granted to a corporate investor is limited in time and cannot exceed 30 years.

Any real estate interest must be filed with the relevant Land Registry to be enforceable against third parties.

Freehold

A person owning the freehold of a property (*pleine propriété*) is the owner in perpetuity. They may use as they please the property, as long as the law does not prohibit it. Subject to exceptions, they own the land and everything above and below it, including all buildings and vegetation.

Two forms of ownership exist. They are very similar to freehold ownership, in that ownership is in perpetuity. These are co-ownership units and volume units.

Co-ownership

Co-ownership may refer to either indivision (governed by the common rules of the Civil Code) or *copropriété* (governed by the Law of 10 July 1965 and its implementing Decree of 17 March 1967). Indivision refers to the situation where several co-owners jointly exercise the same right of full ownership over the same property considered as a whole (and not over a distinct share of the jointly owned property). *Copropriété* refers to the situation where two or more co-owners share the ownership of a property, each enjoying full rights over the private part of the property owned by it and shared rights over the common parts of the property (eg, entrance hall, lift areas).

A property may be divided into a number of co-ownership units, rather like a condominium.

The co-ownership (*copropriété*) system, originally set up to allow a building to be divided into apartments under different ownership, can be used for offices or any other type of building, which is to be divided up among two or more owners. A co-owner owns unit(s) in perpetuity. The co-owner has the exclusive use of the unit for the purpose for which it is intended and a share in the common parts of the property and in the land.

Units can be conveyed in the same way as freehold property.

The French Law dated 10 July 1965 sets up an obligation for each co-ownership to have its own regulations (*règlement de copropriété*), to which the owners are deemed to adhere. The regulations relate to the use and enjoyment of the premises and management of the building.

The co-owners hold a general meeting, at least once a year, to decide on issues that concern the property. The day-to-day management is conferred on a manager (syndic) appointed by the co-owners, who represents the co-owners in dealings with third parties. The co-owners approve the manager's accounts, and make decisions relating to the maintenance and repairs of the property that may be required, and other matters to be decided on. The co-owners are asked to vote on proposed resolutions. The number of votes they have will depend on their share in the common parts and the land. However, where a co-owner has more than 50% of the votes, the number of votes is scaled down to the total number of votes of all the co-owners put together, in order to avoid any co-owner from having a clear majority.

The majority required to pass a resolution will depend on the nature of the resolution to be voted on. The unanimous decision of the co-owners is required for some major issues such as the change of the general assignment of the property, of the enjoyment rules of the property, or of the split of the expenses among the co-owners.

Generally, the expenses of the co-ownership are met by the co-owners in proportion to their percentage share in the underlying land. Certain expenses, however, may be split differently if they are of greater benefit to some co-owners. (One would not normally expect the owner of ground-floor premises to be liable for expenses relating to the elevator for example.)

Volumes

Division en volumes is a contractual technique that consists of dividing the ownership of a property into distinct volumetric shares on different levels that may be located either above or beneath the ground, such shares being three-dimensionally define, and no common parts exist between them.

The division of property into volume units was originally set up to enable the State to allow private ownership of buildings to be constructed over public roads and railways at Paris – La Défense, at Lyon – Part-Dieu and at Montparnasse station in Paris.

It has since become fashionable to use volumes for mixed-use developments, to avoid creating a co-ownership, which is not particularly well adapted for such properties. This is particularly true of mixed-use complexes with different structure or organisation or with different surface each with a different use (for instance, commercial office, retail, etc): a co-owner of retail premises in a shopping mall will not have the same interests as a co-owner of offices in the same real estate complex but may need to have a resolution passed by the co-owners to be able to do certain things.

Volume units are a kind of "flying" freehold. The owner of a unit has the absolute ownership, in perpetuity, of the airspace and buildings within the volume as identified by reference inter alia to the height above sea level. The owner's volume will have the benefit and the burden of all relevant easements.

There can be no common parts in volumes. However, as the provisions of the Law dated 10 July 1965 relating to co-ownership are mandatory, some properties that have been divided into volumes run the risk of being requalified as a co-ownership if they fall within the scope and conditions of the 1965 Law.

Leasehold

There are two categories of leasehold: construction leases (*bail à construction*, see comments below) and other long leases (*bail emphythéotique*, see comments below). As they confer on a tenant a real estate interest, mortgages may be taken over the leasehold right.

Both leases are granted for a term of between 18 years and 99 years. As all leases granted for a term over 12 years, they have to be registered at the Land Registry, and ad valorem duty at the rate of 0.715% has to be paid on the rent with a cap of 20 years' rent if the term of the lease is longer. The lease must be executed as a notarised deed, so it can be registered at the Land Registry.

Such leasehold rights are not to be confused with other leases, such as commercial leases, which do not create any real estate interest.

Construction lease

A construction lease (*bail à construction*) requires the tenant to construct a building on the leased land, which may already be partially built. When the lease expires, the buildings erected by the tenant will revert to the owner of the land.

Long lease

Long leases (*bail emphythéotique*) are almost the same as construction leases. The main difference is that, although the tenant may be entitled under the contract to build on the land, there is no obligation to build. The other difference is that if the premises are used for a commercial activity, the statutory rent review provisions of Article L. 145-1 and following of the French Commercial Code (governing commercial leases) may apply, but never in the case of a construction lease.

Real estate acquisition

Preliminary negotiations and due diligence

The notion of "subject to contract" does not exist in France as it does, eg, in the UK. In the case of a proposed sale, unless the parties intend otherwise, there is a binding contract once the parties have agreed on the main terms of the deal including notably the price for the property. The price is usually agreed at the outset of any negotiations. It is, therefore, essential that each party should be properly advised at the very beginning of any discussions; even if correspondence is exchanged outside France (even then French law could apply insofar as the deal being negotiated relates to a property in France).

Furthermore, although negotiations can be conducted freely, there is an obligation for the parties to negotiate in good faith. This obligation becomes stronger and more binding as the parties' progress towards an agreement. If a party does not conduct negotiations in good faith, that party runs the risk of the other party being entitled to claim damages in tort for the loss suffered.

There is equally a mandatory (meaning that is cannot be waived or limit it) duty of disclosure as set out under Article 1112-1 of the French Civil Code: a party (being the seller or the purchaser) aware of information of decisive importance for the consent of the other must disclose it to the extent that the other party legitimately is not aware of it or trusts his contracting partner. Nevertheless, this duty of disclosure does not apply to an assessment of the value of the performance. Information is of decisive importance if it is directly and necessarily related to the content of the contract or the status of the parties.

Additionally, there is a duty of confidentiality as set out under Article 1112-2 of the French Civil Code: "*A person who without permission makes use of or discloses confidential information obtained in the course of negotiations incurs liability under the conditions set out by the general law.*" (In practice, non-disclosure clauses are already inserted in negotiations preceding sales of business assets or the conclusion of commercial leases, but is now provided by French law.)

A party may be liable if the party brings negotiations to an end abruptly and without any valid and legitimate (such legitimate reasons includes conditions precedent that are not satisfied) reason or fails to reveal information that is likely to prevent the deal from taking place (for instance, giving misleading information on the availability of finance).

A letter of intent or heads of agreement may set out the basis on which the parties are entering into negotiations. The existence of such a letter or agreement will enforce the obligation to negotiate in good faith. Such a document may comprise a number of assumptions. It is important to inform the other party each time an assumption proves to be incorrect or can no longer be relied on.

Preliminary contracts

It is possible to proceed directly to completion, without any preliminary agreement. But almost invariably the parties will enter into a preliminary agreement before dealing with searches and other pre-completion formalities. Also, it may be necessary to obtain consents or building permits before the property can be occupied or developed by the buyer, which can take time.

A properly drafted preliminary contract will stipulate all the terms and conditions (T&C) of the sale. This implies that appropriate due diligence (root of title, easements, planning permission, building insurance, permitted use, the result of searches relating to asbestos, lead, termites, soil contamination, etc) should be done at the outset and not, as still so often happens, after contracts have been executed.

The preliminary agreement usually takes the form of an option granted by the owner to the buyer called “unilateral commitment of sale” (*promesse unilatérale de vente*).

An agreement of sale (*promesse synallagmatique de vente*/*contrat de vente*) may also be used.

The unilateral commitment of sale: call options
In the unilateral commitment of sale (*promesse unilatérale de vente*), the owner undertakes to sell its property to a specific person, the beneficiary.

Accordingly, the seller provides the beneficiary with a free option, either for a fixed or an indeterminate period.

As the commitment of sale becomes a sale as soon as this option is exercised, the commitment must stipulate very precisely at the outset all the T&C regulating the transaction.

In the vast majority of cases, the option is used as a step towards a sale that is expected to happen, and the seller will expect a financial commitment from the beneficiary.

This will typically take the form of a restraining compensation, which will be retained by the seller if the option is not exercised after fulfilment of all the conditions precedent if any. Generally, the amount of the compensation is equivalent to 5% or 10% of the purchase price. This amount will usually be secured by a deposit paid to a stakeholder (which deposit is then applied towards the purchase price if the sale takes place), or by a bank guarantee.

The acquisition is binding on the parties when the buyer exercises its call option.

The parties may also include a penalty clause in their commitment, which stipulates the amount that the party failing to honour its commitment must pay to the other party.

The promisor (the owner) remains bound until the option period afforded to the beneficiary expires.

In rare cases, the seller may also charge a non-refundable price for the option as separate consideration from the price for the property itself.

If the seller withdraws the option before it has been exercised, the buyer will not be entitled to sue for specific performance of the sale. The buyer will only be entitled to claim damages. It is only if the seller withdraws after the option has been exercised that the buyer may be entitled to claim specific performance of the sale, depending on how the contract has been drafted.

However, there are adequate contractual means that can be provided for to discourage the seller from withdrawing their offer to sell.

It is usual to allow the buyer to assign the benefit of the option and substitute a purchaser (be a natural person or a company).

Unless it is notarised (ie, signed before a notary), or reproduced in full in a notarised deed, an option relating to a property must be registered within ten days from the date on which the benefit of the option has been accepted by the buyer, failing which it automatically becomes void. The option must, therefore, be in writing. The rule also applies to the assignment of an option. Notice of an assignment must also be served on the seller by a bailiff (*huissier*).

The agreement of sale
In the agreement of sale (*promesse synallagmatique de vente*/*contrat de vente*), both parties are committed: one party is committed to sell and the other party is committed to purchase, as soon as the property is identified, and its price agreed upon.

Such an agreement will entitle the parties to sue for specific performance if the other defaults.

There is no requirement to register an agreement of sale.

The agreement will usually contain conditions precedent. But once these conditions are satisfied, and unless the parties have agreed otherwise (ie, in the case of a *promesse synallagmatique* de vente "*ne valant pas vente*"), the sale becomes binding and effective retroactively from the date on which the contract was entered into. It is, however, possible and usually desirable to contract out of the implied retroactive effect.

As in the case of options, it is generally possible for the buyer to assign the benefit of the contract, but this must be done before all the conditions precedent are satisfied, failing which there could be deemed to be two successive transfers for transfer tax purposes. As in the case of options, property dealers are not permitted to sell on the benefit of an agreement of sale.

The pact of preference (*pacte de préférence*)
In the pact of preference, the owner is committed, if he finally decided to, to negotiate with the beneficiary of the pact only.

Taking up the case law of the Court of Cassation, the new French law of obligations states now that "*should a contract be concluded with a third person in breach of a pact of preference, the beneficiary may obtain reparation for the prejudice suffered. When the third person knew of the existence of the pact and of the intention of the beneficiary to take advantage of it, the beneficiary may also bring an action in nullity or request from the court that he be substituted for the third person in the contract that was concluded*".

Third parties wishing to conclude a contract with the preference debtor may now ask the beneficiary of the preference what his intentions are in the matter. In fact, "*the third party may give written notice to the beneficiary requiring him to confirm, within a period which the former fixes and which must be reasonable, the existence of a pact of preference agreement and whether he intends to take advantage of it*". It is highly likely that the beneficiary of the preference, faced with an enquiry relating to a contract, responds in the affirmative, even if only to block the situation, insofar as he has no obligation to make the acquisition, unless there is a stipulation to the contrary.

Formalities

Once contracts have been executed, the following pre-completion searches and other formalities will be carried out:

- Land registry searches: to check that there are no mortgages or other charges registered against the property or, if there are, that the sale proceeds will be sufficient to discharge the mortgages.
- The waiver of pre-emptive rights:
  - Urban pre-emptive right: the local municipality (or, in rural areas, the local agricultural authority known as the SAFER) could have a priority in purchasing specific property up for sale in areas that have been defined beforehand by the town council. A seller (acting in practice through its notary) must notify the local public authority of the contemplated sale's T&C including the price by filing a declaration of intent to alienate (*déclaration d'intention d'aliéner*, or DIA) the property, In this case, the buyer has to enquire (usually through its notary) with the proper authority whether it intends to exercise its right.. If the local public authority wants to purchase the property, it then has two months (unless period is extended) to give notice of its intention to acquire the asset, stating whether it intends to purchase it at the price mentioned in the DIA or at a lower price. Absent any reply in the above period, the authority is deemed to have waived it purchase right.
  - Tenant's pre-emptive right: the French law grants to the tenant a priority in purchasing the leased accommodation that the owner wants to sell.
- Other local planning search: to check whether the property is located in a zoned area and, if so, the authorised plot density ratios, and whether the property is burdened by any public easements.
- Obtaining certificates from the authorities confirming that the premises have the requisite use, is not in a termite zone, etc.
- A certificate from the managing agent (syndic) of premises, which are part of a co-ownership. This certificate must state that the seller does not owe any money to the co-ownership.

The purchase will be conditional on satisfactory searches being obtained and the beneficiary of any pre-emptive right confirming that it will not be exercising such a right.

Planning permission and other consents

The purchase may also be conditioned by the delivery of certain permits, licences or consents, which the purchaser may require. The following are frequently encountered:

- a demolition permit;
- a building permit, required to erect a new building, or for works to an existing building if these are to change its existing use, change the exterior of the building or its volume, or create additional floors;
- a licence, commonly known as "CDAC licence", required to create new retail premises with a sales floor area over 1,000 square metres, or to change one retail category into another if the sales floor exceeds 2,000 square metres as well as to create cinemas with seating for more than 300 people (1,500 people in some cases);
- a licence, known as an "*agrément*", required to build, re-build, extend or occupy offices, warehouses and industrial premises in the Paris region, which are over a certain size;
- a consent, required to convert residential premises to offices, or any other use (noting that the changing office premises into residential premises is not subject to this prior authorisation of the French Administration).

Deed of sale

The deed of sale must be executed before a French notary. It is usually preferable for each party to appoint its own notary (in which case, the notaries' fee is split between the two notaries). The deed of sale will identify the parties and the property and set out the T&C of the sale and a full root of title, which has to be established over at least a 30-year period.

As a general rule, a seller will seek to sell the property without giving any warranty with regard to apparent or hidden defects. However, if it can be established that the seller knew of a hidden defect but did not disclose its existence to the buyer, the buyer may be entitled to claim damages from the seller for any loss suffered.

In any event, a seller who is regarded as being a property "professional" cannot contract out of the statutory warranties provided by the French Civil Code, except if it sells its property to another professional.

The seller of a building constructed in the past ten years is liable to all future owners during the ten-year period in respect of all structural defects (*garantie décénale*).

Post-completion formalities

Once the deed has been executed, the notary will lodge a copy with the Land Registry for registration and arrange for any outstanding mortgages to be removed.

Acquisition costs

Unless otherwise agreed, the buyer bears all acquisitions costs, including the notaries' fees and expenses, the land registry fees and the registration duty.

Notary's fees and expenses

Notary's fees are calculated by reference to the purchase price, plus VAT. They are computed as followed and based on the purchase price:

- from 0 EUR to 6,500 EUR: 3.945%;
- from 6,500 EUR to 17,000 EUR: 1.627%;
- from 17,000 EUR to 60,000 EUR: 1.085%; and
- over 60,000 EUR: 0.814%.

As from 1 January 2021, notary fees should be reduced as follows:

- from 0 EUR to 6,500 EUR: 3.870%;
- from 6,500 EUR to 17,000 EUR: 1.596%;
- from 17,000 EUR to 60,000 EUR: 1.064%; and
- over 60,000 EUR: 0.799%.

Where two notaries are involved, they will share the fees. If the purchase is being financed by means of a loan to be secured by a charge over the property, a fee will also be payable in that respect. The fee is approximately 0.55% plus VAT of the amount secured by the charge. Expenses relate essentially to pre- and post-completion searches. Notaries' fees are negotiable above 100,000 EUR.

Land registry fee

A land registry fee equal to 0.1% of the purchase price on the purchase and 0.05% of the amounts secured by the mortgage (or any other charge over the property) is payable.

It should be noted that a privilege less expensive than a mortgage can be granted, the so-called "*privilège du vendeur*" or "*privilège de prêteur de deniers*".

Tax aspects

Taxation of the acquisition of real estate

Either VAT or registration duty (or both) is/are payable on the purchase of real estate in France.

VAT

The VAT regime applicable to the purchase of real estate depends on the VAT status of the vendor. In substance, if the vendor performs a VAT-able activity on a regular basis (ie, if the vendor is an "*assujetti*", hereinafter a "VAT-able person"), VAT at the current standard rate of 20% would be payable by the vendor. Conversely, except in limited cases, no VAT would be mandatorily due if the vendor is not a VAT-able person. In addition, VAT and registration duties are disconnected as the registration duty liability depends solely on the intention expressed by the buyer (ie, intention to resale/erect/rebuild the building). The following cases illustrate the principles herein above-mentioned:

- The disposal of building land (*terrains à bâtir*) by a VAT-able company, the vendor will be subject to VAT. If the buyer intends to erect a building on the land, she/he would be subject to a 125 EUR registration duty, provided that the buyer undertakes to complete the building works within four years and complies with the undertaking. This deadline may be extended automatically for a year if the works have commenced by then. Further extensions not exceeding one year each time may be granted if this can be justified by force majeure or other very good reason.
- The purchase of a building to be demolished or to be entirely reconditioned would also be subject to VAT if the vendor is a VAT person. The 125 EUR registration duty would apply, provided that the purchaser undertakes to complete the construction within a four-year period.
- The vendor of a building in the course of construction would also be liable for the VAT. Registration duty at the rate of 0.71498% would be payable by the buyer.
- The purchase of a new building within the first five years from the date on which it was built would also give rise to VAT for the VAT-able vendor. Registration duty at the rate of 0.71498% would also be payable by the buyer.

VAT is calculated on the purchase price increased by any other consideration provided to the seller. Unless the parties agree otherwise, the VAT is due by the buyer. If the FTA consider that the actual market value of the property is higher than the price or the market value declared, they could levy VAT on the actual market value.

According to the tax rules and to administrative guidelines, the acquisition of a real estate property subject to VAT may benefit from a VAT exemption provided that:

- the property is not a building land; in that case, the vendor may elect for VAT;
- the property is completed for more than five years; the vendor may also elect to submit the sale to VAT;
- the vendor is not a VAT-able person.

Registration duty

The total effective rate of registration duty is, as a matter of principle, 5.80665% (or 5.09006% in certain French departments).

Registration duty is calculated on the purchase price increased by any other consideration provided to the seller. Unless the parties agree otherwise, the cost of the registration duty is borne by the buyer.

If the FTA consider that the actual market value of the property is higher than the price or the market value declared, they could levy registration duty on the actual market value.

In this case, the FTA would charge interest for late payment at 0.2% per month (ie, 2.4% per year). Furthermore, an additional charge of 40% will apply if bad faith is established, or 80% if a fraudulent intention can be demonstrated.

For companies or branch offices in France, registration duty is fully tax-deductible, either as expenses, or by way of depreciation allowances where transfer duties are capitalised.

Article 50 of the Amending Finance Act for 2015 added an additional tax on the sales of offices in the Ile-de-France region. Under this new rule, the sale of office premises, commercial premises and warehouse which are considered as old building for VAT purposes are subject to the 0.6% tax rate. This tax is assessed, recovered and controlled under the same procedures and under the same penalties than the registration fees. This surtax is not applicable when the acquisition is exempt of RETT (in case of commitment to build) or if the reduced rate of 0.714985% applies.

In addition, the rate is only 0.714985%, if the purchaser takes a commitment to resell the property within five years after the acquisition; or only 125 EUR if the purchaser takes the commitment to build a new building (within the meaning of French VAT regime) within four years.

Taxation of income and capital gains

Income from, and capital gains realised on the sale of, real estate in France are taxable in France, whether a French resident or a non-resident receives them. The same rule applies to the gain made on the sale of shares in a company whose assets consist mainly of French real estate, regardless of whether the company is French or not.

These principles are subject to those of any applicable tax treaty for the avoidance of double taxation, in the case of a non-resident of a State with which France has entered into such a treaty. France has entered into approximately 100 such treaties.

According to Article 6 of the OECD Model Convention, the form followed by France in the case of many treaties, provides that real estate income and capital gains are taxable in the State where the property is located. Obviously, only a case-by-case analysis will determine if France has the right to tax or not and there are still few exceptions, especially in the case of old treaties.

Generally speaking, it can, as a result be said that the same rules will apply to rental income realised by a French or a non-French resident, while, as concerns capital gains, there are specific rules for non-residents holding, directly or indirectly, French real estate assets.

In addition, the Multilateral Instrument (MLI), signed 7 June 2017, and its Article 9(4) provides a new land rich clause for double tax treaties (DTTs): "*gains derived by a resident of a Contracting Jurisdiction from the alienation of shares or other rights of participation in an entity may be taxed in the other Contracting Jurisdiction provided that these shares or rights derived more than a certain part of their value from immovable property (real property) situated in that other Contracting Jurisdiction, or provided that more than a certain part of the property of the entity consists of such immovable property (real property)*".

France noticed its intention to apply the provisions of Article 9(4) to its DTT in force. In order for such article to apply to a DTT signed by France, the contracting jurisdiction should not make any reserve for application of Article 9 of the MLI and notice its intention to apply paragraph 4 of Article 9 of the MLI.

On 12 July 2018, France ratified the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent BEPS (MLI), by way of Law No 2018-604, as published in Official Journal No 0160 of 13 July 2018. MLI entered into force in France as from 1 January 2019.

Permanent establishment

In principle, the ownership of a French property by a non-French company does not in itself constitute a permanent establishment (PE) in France.

Nevertheless, the direct holding of French properties may constitute a PE either when the conditions provided by the PE article of the relevant tax treaty are met, or in the absence of a tax treaty, when one of the following criteria is met:

- The non-French company carries on part of its activities in France through a fixed place of business.
- The activities of the non-French company in France cover a "complete commercial cycle" (applies only in a non-treaty context).
- The non-French company carries on activities in France through a dependent agent acting on its behalf and which has an authority to conclude contracts in the name of the company (eg, conclusion of lease agreements).

Should the French property constitute a PE, the net after-tax profit would be deemed to be distributed and subject to a branch tax at a rate ranging from 0% to 15% in the presence of a tax treaty, or a fixed rate of 28% otherwise. The branch tax could, nevertheless, be mitigated:

- if the net after-tax profit has been distributed to French shareholders, no branch tax is due; or
- if the head-office of the branch is located in one of the EU Member States and is liable to CIT, no branch tax is due; or

- if the effective distribution is lower than the net after-tax profit, the branch tax would be levied only on the profits distributed.

Further, the Finance Act for 2020 (following the case law Cofinimmo, CE 10/07/2019 n°412581) introduced an exemption of branch tax if the foreign head office company is in position to demonstrate that the income of the permanent establishment was not disinvested from France. In practice, this exemption which applies to financial years opened as of 1 January 2020, will only concern European companies that are not liable to CIT in the state where they are tax resident (EU companies subject to CIT being exempt from the branch tax).

In addition, Article 10 of the MLI provides anti-abuse rules for PEs situated in a third jurisdiction. Indeed, the MLI permits the source state to refuse the granting of the DTT benefits, in case of income being obtained through a permanent establishment of the resident entity, situated in a third state, which taxes at a level below 60% of the tax that would be due in the state of residency of the entity having a PE in the other contracting state.

Corporate tax

The taxable rental income corresponds to the gross rental income minus deductible expenses both determined on an accrual basis, whether realised directly, or through a given French vehicle.

If the investment is realised through the most common corporate structures – French limited liability companies such as *société anonyme* (SA), *société par actions simplifiée* (SAS), or *société à responsabilité limitée* (SARL) – the income is subject to French corporate tax.

The standard rate of CIT is 28% (for companies whose turnover exceeds 250,000,000 EUR applicable CIT rate is 31% for the portion of the taxable income exceeding 500,000 EUR). This rate will progressively be reduced to 25% by 2022, as follows:

- in 2021: all profits will be subject to CIT at the rate of 26.5% (except for the companies whose turnover exceeds 250,000,000 EUR where the applicable CIT rate will be 27.5%); and
- in 2022: all profits will be subject to CIT at the rate of 25%.

The standard rate of 28% is increased by a 3.3% social surcharge that applies for companies with an annual turnover of at least 7,630,000 EUR and whose CIT liability (standard rate and the reduced rate) exceeds 763,000 EUR on the part of the corporate tax which exceeds 763,000 EUR.

Thus, the resulting effective rate will be: 28.92% in 2020 (for companies whose turnover exceeds 250,000,000 EUR, the applicable CIT rate is 31.02% for the portion of the taxable income exceeding 500,000 EUR), 27.37% in 2021 (or 28.41% for the companies whose turnover exceeds 250,000,000 EUR), and 25.83% in 2022.

There is no specific rule governing the taxation of either real estate income, or capital gains when French companies make the investment.

When the investment is realised through a partnership type company, which has not elected to be liable to corporate tax, such as unlimited liability partnerships in the form of a *société en nom collectif* (SNC), or a *société civile* (SC), the taxable income is determined at the level of the company, but the burden of tax lies in the hands of the shareholders.

The tax regime applicable to non-resident shareholders is, therefore, rather complex, and it is necessary to examine the relevant tax treaty in order to determine if, in addition to French corporate tax, French tax at source will be levied, either on dividends, or on income of partnership type companies.

Personal income tax

Where a taxpayer holds a property directly or through a tax transparent company, such as an SNC or SCI, the taxable rental income corresponds to the cashed rental income minus deductible expenses paid.

The net rental income received by a non-resident is subject to rates ranging from 0% to 45%. However, a minimum rate of 20% applies unless the taxpayer can demonstrate that had the taxpayer been resident in France, his/her effective rate of taxation would have been lower than 20%.

The Finance Law for 2018 introduced a flat tax (*prélèvement forfaitaire unique*) of 30% (12.8% as personal income tax and 17.2% as social contributions) on investment income (dividends, interest and capital gains, but excluding real estate income and capital gains). This flat tax is a final settlement of the taxpayer's liability. The taxpayer may, however, elect to be taxed on all investment income received during a given tax year, on the progressive income tax rate system, in which case the flat tax is merely regarded as an advance payment, any excess being refundable. The option is made on a yearly basis and is irrevocable for the tax year concerned.

Since 1 January 2019, taxpayers bear a WHT directly on their taxable rental income (and social contributions of 17.2%). This is the standard regime for the payment of income tax by individuals since 1 January 2019.

Registration duty

Regarding registration duty (*droits d'enregistrement*), French tax provisions will apply, in principle, on any transaction performed on a local asset.

VAT

If the rental activity is liable to VAT, the owner will be entitled to recover the input VAT paid on the acquisition of the real estate property, if any, and/or the VAT paid on all its further purchases of services or goods (VAT credits are either deductible or refundable). VAT refund claims can be filled on a monthly basis.

Purchase of a real estate company

Legal aspects

Unlisted real estate companies are limited liability companies, typically a SA, SAS or SARL, or unlimited liability companies, typically a "*société civile immobilière*" (SCI) or an SNC.

In addition to a full due diligence over the company itself and as in the case of a direct purchase of the real estate, a full due diligence of the underlying real property has to be conducted. The seller would be expected to provide, as in the case of an ordinary share deal, warranties and an indemnity in respect of any undisclosed liabilities and any undisclosed matters that adversely affect the company's assets.

Unlike the case of a direct real estate purchase, the intervention of a notary is not mandatory. The seller and buyer typically instruct their usual lawyers and other advisers to advise them in connection with the deal.

For the purchase of all the shares of an SCI, the buyer may have to purge the urban pre-emptive right of the local municipality, but only in very specific cases:

- if the local municipality has set up a reinforced urban pre-emptive right (*DPU renforcé*) for the area in which the company is located;
- if the only asset of the purchased company is a property which would have been subject itself to this urban pre-emptive right;

If those conditions are met, the buyer will have to follow the same procedure as described above under section "*Formalities*" (DIA).

After the due diligence process, a share purchase agreement is drafted as well as a representations and warranties agreement.

Tax aspects

Registration duty on the purchase of shares

In principle, a transfer of shares is subject to 0.1% transfer duty for the transfer of shares in listed or unlisted companies limited by shares. In practice, listed companies are rarely subject to the transfer duty of 0.1%.

The rate applicable to the transfer of equity interests in companies whose capital is not divided into shares (eg, partnerships as SNC or SCI) is 3%.

The rate applicable to the transfer of interests in real estate companies, regardless of the corporate form of the company sold is 5% with the exception of stock-listed companies.

A "real estate company" is defined as being a company whose assets predominantly comprise (or have comprised at any time during the year preceding the time of the transfer) properties in France or shares in "real estate companies". This definition is extremely wide. For example, a company that owns both an industrial business and the building in which the industrial business is operated would be regarded as a "property company" if the value of the building exceeds the value of the business and other assets owned by the company.

This 5% duty is also applicable to sales of non-French companies meeting the above assets test.

Since the rate of transfer duties levied on a sale of a real estate company's shares is close to the one levied on a sale of property, buyers are now much more likely to prefer buying the real estate rather than the company which owns it. The advantages of a direct purchase are the following:

- It is more straightforward.
- It allows a charge to be taken over the real estate to secure the financing of the purchase.

- The building can be fully depreciated on the basis of the purchase price (and not its historical book value as it is the case with a share deal).
- There is no latent capital gain to monitor post-transaction.

But in certain cases, it may still be more advantageous to acquire the company. Also, in the current market, a seller might prefer to sell the shares in the company for the following reasons:

- The gain resulting from the transfer of shares may be exempt in certain cases if the seller is a non-French seller.
- The 5% duty will only apply on the market value of all the assets (including the real estate properties) held by the company reduced by the debt.
- The seller passes on any risks/liabilities that the latter does not specifically warranty.

The debate remains open, and sellers and buyers might, as a result, have contradictory/opposite goals.

Direct tax liabilities

As opposed to an asset deal scenario where the purchaser does not bear any previous tax liability in connection with the property itself (save for the royalty due on development of office premises), if the vendor is in default, in a share deal scenario, the purchaser will inherit all current or pending tax liabilities which may exist at the level of the target company, one of the most significant of them being the 3% annual tax liability.

Consequently, as part of the due diligence exercise, the purchaser should carry out a tax review of the company before the purchase and negotiate a price discount and/or a tax warranty in order to protect its interests.

Construction issues and new buildings

Legal aspects

Purchase of a new building under a “turnkey” contract

It is not unusual for a developer to sell a new building in the course of its construction on the basis of a “turnkey” sale and purchase. The buyer will generally make an initial payment at the execution of the deed of conveyance commensurate with how far the works have progressed. Further stage payments will be made as and when the building works progress.

The trend is now for institutional buyers to pay an initial deposit at the outset and the entire balance of the price when the building is completed (the developer’s additional financing costs will be incorporated in the agreed price to reflect this). The final price may be adjustable depending on the level of the rental income achieved, ie, the seller shares with the buyer the risks and benefits linked to the level of rents achieved for the property.

A seller will want insurances that the buyer will meet its obligation to pay the balance of the price. Usually this will take the form of a bank guarantee. The buyer will want to ensure that the seller completes the building that complies with an agreed specification, which should be sufficiently detailed, within an agreed time frame.

The deed of conveyance will typically be divided into two sections, the first dealing with the general T&C of the purchase, and the second dealing with the related seller’s construction obligations.

The buyer will have the benefit of a guarantee from the seller, backed by an insurance policy, against all hidden defects of a structural nature, or which affect the installations that are incorporated into the structure and which appear during the ten years following the date on which the building is completed. This guarantee and insurance also benefit all subsequent owners during the same period. Hidden defects to other installations in the building benefit from a two-year guarantee.

Special public policy rules, outside the scope of this discussion, apply to residential property, even where an institutional investor acquires an entire apartment building.

Regulatory issues

Both the Planning Code (which applies nationwide) and the Construction and Housing Code (which also applies nationwide) regulate building works. Local land use plans (*plan local d'urbanisme* , or PLU)/*plan d'occupation des sols* , or POS) regulate zoning and urban planning.

Development plan

A development plan (*schéma de cohérence territoriale*) is prepared by municipalities that have social or economic interests in common.

The development plan, which may be revised periodically, formulates policy and general proposals for development and use of land and the infrastructure in the area, so as to achieve a balance between urban development, farming and other economic activities and to preserve the quality of the air, of the countryside and of urban areas.

Local authorities may be given the power to acquire land by compulsory purchase for planning and related purposes.

Local land use plans (PLU/POS) regulate zoning and urban planning. They are prepared by a local municipality (or several municipalities together) for all or part of the land within its district. The land within the perimeter of the plan is zoned for different use and building density ratios are attributed to each zone. The land may be comprised in a development zone called a "*zone d'aménagement concerté*" (ZAC), which may have its own rules.

Building or demolition permits

In general, any development of land in France requires a formal application for building permit to be made to the local planning authority and the development may not be carried out unless such permit is granted.

A building permit is also required in the following cases:

- works to convert the use of an existing building;
- any change to the exterior (shop front, addition of a balcony) or the volume of the building;
- the creation of additional floors.

The building permit must comply with the development plan, the local land use plan as well as specific legislation, which, for instance, restrict building in coastal or mountain areas.

Works to destroy a building require a demolition permit.

The building permit is not granted for a specific period. However, it will lapse if the building works are not commenced within two years (this deadline may be extended by one year) from the delivery of the permit or if the works are interrupted for one year (or three years in the case of certain phased developments).

Once granted, the building permit is attached to the land and will pass to any subsequent owners, on condition that the planning authorities are informed of the transfer and the original owner of the land agrees to the transfer. The authorities then issue a modified building permit showing the identity of the new owner responsible for the works.

A transfer is not required in the case of a "turnkey" sale, as the seller remains responsible for the works until the building is completed.

Other consents

Other consents may be required as a prerequisite to building permit or even where building permit is not required.

- A licence (commonly known as "CDAC licence") is required to create new retail premises with a sales floor area of over 1,000 square metres, or to change one retail category into another if the sales floor exceeds 2,000 square metres as well as to create cinemas with seating for more than 300 people (1,500 people in some cases).
- A licence, known as an "*agrément*", is required to build, re-build, extend or to occupy offices, warehouses and industrial premises in the Paris region, which are over a certain size.
- Specific authorisations (*autorisation d'exploitation commerciale*) may also be required to operate a commercial activity (such as retail premises and cinemas) beyond specific legal thresholds.
- Authorisations to operate classified facilities for environmental protection (*installations classées*) may also be required.
- A discretionary consent is required to convert residential premises to offices, or any other use.

Environment law

Recently there has been a trend towards the creation of wider power and controls over the use of land and the environment that has increasingly taken the form of administrative powers exercisable by public authorities.

Specific rules under a Law of 1976 govern "*installations classées*" which are factories, workshops, warehouses, building sites, quarries, and generally any installation operated by or in the possession of any person which may be dangerous or be the cause of nuisance for the neighbourhood, for health and safety, for agriculture, for the environment or for sites and monuments of interest. A nomenclature identifies the different types of "*installations classées*" showing a classification level, according to the potential risks to the environment, and these require that the operator of the facility obtain a prior authorisation or declaration depending on how serious a risk the installation may be. Breach of such rules may expose the operator to be held liable from an administrative, civil or criminal standpoint.

Even if an installation is not an "*installation classée*", it may be caught by other legislation relating to waste and noise pollution or the pollution of air and water depending on the type of the installation, the products produced and stored, and the substances discharged into the drainage system and into air.

In certain areas there is a prohibition on construction, eg, in conservation areas of natural beauty, near airports and near certain "*installations classées*". Special rules also restrict development in the mountains and along the coast.

The seller usually retains technical advisers and/or surveyors, dealing with all technical and environmental aspects of the real estate asset, including construction specifications, works, classified facilities, safety regulations and technical reports in order to issue a report, showing notably whether or not there is asbestos in the false ceilings, lagging or flocking in the building, and what measures need to be taken, if appropriate.

Historic buildings

Any works of demolition, alteration or extension of buildings listed in whole or in part as being of historic or artistic importance (*monuments historiques*) require a special authorisation from the Arts Minister and are overseen by the authority responsible for listed buildings (*Administration des Beaux-Arts*).

In the case of works to other buildings of interest, listed as a subcategory of historic monuments on a supplemental inventory, prior notice must be given to the Arts Minister.

Building works

Architect

An architect must be employed for all building works for which a building permit is required, except when a building permit is applied for by an individual for their own use and for a project which does not exceed a certain threshold (a net built floor area (SHON) of 170 square metres in the case of non-agricultural buildings). The employer may also engage a quantity surveyor who measures the amount of work and materials necessary to complete the plans and sets this out in detail in bills of quantities.

Builder's liability

Ten-and two-year liability
"Builders", who are defined by the Civil Code to include contractors, architects and other consultants involved with construction works or their design, are deemed liable towards the employer and any subsequent buyer for ten years from the handover of the works for the repair of any defects notified by the employer, which compromise the solidity of the works or effect their constituent elements (services, foundations, structural, enclosed or covered areas), or fixtures and which make the building unfit for its normal use.

During a period of two years from handover of the works, the builder is similarly liable for the repair of any defects notified by the employer, which effect fixtures that are detachable from the constituent elements of the works.

Such presumed liability is mandatory: it is not possible to contract out of it. But it is possible to rebut the presumption. If the builder can establish that she/he was not liable, she/he can avoid liability.

The builder may also be liable under the contract for negligence.

Liability for apparent defects
During the period of one year from handover of the works, the building contractor is liable for the repair of any defects notified by the employer, either through the "reserves" (reservations) procedure or by written notification in the case of damage arising after handover of the works. The employer and contractor agree by when the defects must be remedied, failing which the court can determine this.

Insurance

Builder's insurance
The builder is required to take out insurance to cover their liability for defects covered by the ten-year defects liability period ("*responsabilité décennale*" insurance).

In addition, an employer will want to ensure that a builder has taken out adequate professional indemnity insurance to cover their liability arising through negligence.

Insurance by the *maitre de l'ouvrage*
The *maitre de l'ouvrage* (future owner of the property once the constructions and works are completed) is required by law to take out insurance, for the benefit of itself and future owners, to cover the cost of remedying defects covered by the builder's ten-year defects liability period ("*dommages-ouvrage*" insurance). Neither a company over a certain size (as defined by Article R.111-1 of the Insurance Code), nor the state is obliged to take out such insurance if the building works are carried out for its own use and do not relate to residential buildings.

The builder is required to take out insurance to cover its liability for building works, which are covered by the ten-year defect's liability period ("*responsabilité décennale*" insurance).

These insurance requirements are mandatory. Insurance should be taken out before the works are carried out.

The purpose of the "*dommage-ouvrage*" policy is to enable the owner to receive insurance money quickly to remedy the insured defects. The insurer paying under that policy will then seek to identify who, among the builders and consultants, was liable, and their respective share. The liable builders will be covered by their respective "*responsabilité décennale*" policy.

It is prudent to ensure that extra cover is taken in both types of policies, ie, to cover damage to adjoining buildings, defects covered by the two-year defects liability period, incorporeal loss resulting from insured loss, liability for errors from omissions and the cost of clearing rubble.

In addition, *the maitre de l'ouvrage* will typically require the builder to have professional indemnity insurance, covering negligence and contractual liability and will take out site insurance to cover any damage to the works.

Security in favour of the builder

Article 1799-1 of the Civil Code requires the *maître de l'ouvrage* to provide the builder with security for payment of the price where the amount due exceeds a certain threshold. If the employer has recourse to a loan, the sole purpose of which is to finance the entire cost of the works, the lender cannot advance monies under the loan to anyone other than the contractor, until all monies due to the contractor have been paid. If there is no such loan or the amount is insufficient, and in the absence of any other security, a guarantee from an appropriate financial establishment must be granted.

Subcontracting

Subcontracts are governed by the French Law dated 31 December 1975, the provisions of which are mandatory. If a contractor subcontracts all or part of the work, the identity of the subcontractor and the T&C of payment must be approved beforehand by the employer. If not paid by its principal contractor, the subcontractor has a right to seek direct payment from the employer under the conditions provided by the law.

Tax aspects

VAT

VAT at the standard rate (currently 20%) is charged on the provision of construction services and works.

The developer can recover the input VAT in accordance with the ordinary rules, as follows:

- If the purchaser intends to use the building for its professional activities, VAT will be recoverable according to the purchaser VAT recovery ratio.
- If it is envisaged to let the building, the landlord may elect to charge VAT on the rents on unfurnished and unequipped premises. The election is made for a nine-year period on a building-by-building basis, and not on a lease-by-lease basis. The election is effective even in the case of leases to tenants, which are exempt from VAT, provided the lease expressly refers to the landlord's VAT election. The election should be made as soon as is possible to secure input VAT deduction rights.
- Absent of any VAT-able activity, or if the election to charge VAT on rents is made lately, the rights of the investor to recover input VAT could be seriously jeopardised or even eliminated.

It is therefore critical that VAT elections be implemented from the very beginning, to improve the net performance of the investment. Lost input-VAT recovery would qualify as a fixed asset or as an expense only depreciable or

deductible against corporate tax, ie, a maximum 28.92% (ie, standard CIT rate plus 3.3.% additional contribution) recovery instead of 100%.

Corporate tax

The construction of a building does not raise any specific issues as regards corporate tax. Until completion the constructions will be booked as "assets in progress" so that no depreciation will be possible before being fully accounted for as fixed assets.

Office premises development tax

There is a specific tax for development of office premises within the Paris area (*taxe pour création de bureaux en Ile-de-France*) whose rates vary from district to district from 0 EUR to 417,49 EUR per square metre.

It is paid only once and is not allowed as a deduction in computing rental income because it is deemed to be part of the acquisition cost of the land (neither deductible nor depreciable); it will, therefore be taken into account only in computing taxable gains upon a disposal.

Financing the acquisition of French real estate

Legal aspects

Loans

If the purchase price is financed by means of a loan, the lender will usually require security over the property. There are various kinds of security available.

Mortgages

A mortgage (*hypothèque*) created by contract must be recorded by a notarised deed, so that it may be registered at the land and charges registry. A mortgage may also arise from a judgement or by virtue of a statutory right.

Mortgages take effect from the date on which they are registered at the land and charges registry. Duty at the rate of 0.715% is payable, calculated on the amount secured. In addition, land register fee of 0.05% and notary fee of 0.447% (excluding VAT) is also applicable.

A mortgage can be granted by the owner at any time, and so can be provided by the buyer to a lender to secure any loan she/he may need after the acquisition (for instance, to finance the cost of works).

"Privilèges"

Certain creditors have the benefit of a special charge known as a "*privilege*". These include the seller of a property for the payment of the price if not fully paid on completion (*privilège de vendeur*) and a person who advances the funds to the buyer to finance the purchase price, provided certain conditions are satisfied (*privilège de prêteur de deniers*).

A "*privilege*" is a charge over the real estate in the same way as a mortgage, save that the "*privilege*" takes effect retroactively from the date on which the deed of conveyance is executed. The "*privilege*" must be registered within two months from the date of the conveyance, failing which it becomes a mortgage, with no retroactive effect. The registration of a "*privilege*" is not subject to the 0.715% duty but is subject to land registry fee of 0.05% and notary fee.

"Antichrèse"

This is a real property interest (interest in rem) where the owner transfers possession of the real estate to a creditor by way of security. The creditor receives the income derived from the real estate, which is used to pay off the interest, and any surplus is deducted from the principal outstanding under the loan. The agreement must be in the form of a notarised deed so that it may be registered at the land and charges registry. This form of security is very rarely used. The registration triggers the payment of duty at the rate of 0.715% unless the "*antichrèse*" is granted to the creditor under the loan agreement.

Leasing agreements ("*crédit-bail*")

Leasing agreements have often a 12- to 15-year duration, the lessee having the right to exercise its option to acquire the property at the end of the lease, or earlier as may be provided under the contract.

Minimum equity funding requirements

Besides thin capitalisation rules for tax purposes described hereafter, there are minimum share capital requirements for certain French companies.

- SA: 37,000 EUR (except for certain specific activities), of which at least 50% must be immediately paid-up, and the remainder within five years.
- SAS: no minimum share capital is required but at least 50% must be immediately paid-up, and the remainder within five years.
- SARL: no minimum share capital is required. May be 1 EUR to be paid-up on incorporation. At least 20% must be immediately paid-up, and the remainder within five years
- SCI or SNC: no legal minimum.

French Company Law also requires certain companies, such as a SA, SAS and SARL, to have a minimum level of net equity (*capitaux propres*). When the net equity falls below 50% of the issued share capital, the company will need to restore such a situation within two years.

Such a thin capitalisation rule does not apply to partnership type vehicles such as an SCI or SNC.

Tax aspects

Finance lease

The tax regime of these contracts has been totally amended for those concluded as of 1 January 1996. The current rules are set out below (other rules apply for contracts concluded before this date).

Publication of the contract

If the lease is granted (usually by a dedicated financing company) for a period exceeding 12 years, the contract must be registered at the Land Registry and this gives rise to registration duty at the rate of 0.71498% levied on the total rents (minus that part of the rent that corresponds to the financing costs) payable over the entire duration of the lease (subject to a cap of 20 years if the lease exceeds that duration).

Rental tax or VAT on rents

Rents are either subject to VAT at the standard rate of 20% if the rented premises are professional furnished ones or if the lessor has elected for VAT. Otherwise, rents are liable to a rental tax equivalent to 2.5% of the annual rent if the building is over 15 years old.

Tax deductibility of the rents paid by the lessee

In principle, rents are tax-deductible, except for the portion that corresponds in fact to non-depreciable assets (ie, essentially the land), with several specific rules for office premises located in the Paris area and completed after 31 December 1995. The financing company itself communicates the amount of the rent that is deductible to the tenant.

Purchase of the building at the end of the lease

The purchase of the building by the tenant at the end of the finance lease gives rise to registration duty at an effective rate of 5.80665% (or 5.09006% in certain French departments), which is calculated on the option price only. However, VAT may apply instead of registration duty in the rare cases where the option is exercised within five years from the date on which the building was completed.

In the case of finance leases signed since 1 January 1996, the rate of duty will be calculated on the market value of the property, appraised as of the date of the purchase by the tenant, if the finance lease was granted for more than 12 years and the contract has not been filed at the Land Registry.

From a corporate tax point of view, the lessee must, in principle, add back to its income an amount equal to the following:

The value of the building at the date of the conclusion of the finance lease contract, less:

- the price payable under the option;
- the amount of the depreciation which could have been recorded by the tenant had it been the owner of the premises minus the part of the rents which were not tax-deductible.

Loans

Tax deductibility of interest on loans

Under French law, there is no mandatory debt-to-equity ratio regarding the means through which a French company may manage its indebtedness (except for the thin capitalisation considerations relevant for the net financial expense deductibility limitations under ATAD I rules – please see below).

However, the FTA tend to look more and more closely at the level of indebtedness of companies. A French company should not borrow from a company within the group to which it belongs, an amount which it could not have obtained from a third-party lender and it should always be able to pay all its financial charges as they fall due.

The financial charges borne by a French company in consideration for a loan contracted for the needs of its activity (eg, in order to purchase assets) are tax-deductible, providing that the T&C of the loan are on an "arm's length" basis.

In addition, ATAD I and ATAD II rules apply.

Interest rate limitation

The interest paid to related parties is limited to the highest of:

- interest rate published by the FTA (ie, 1.32% for financial years closing on 31 December 2019);
- interest rate that the borrower could have obtained from an independent bank under similar conditions (supported by documentation or transfer pricing studies).

General limitation of net financial expenses (ATAD I)

The Finance Bill for 2019 has implemented into French tax law the provisions of the Anti-Tax Avoidance Directive (ATAD I).

The new rules apply to the net financial expenses of an entity. Their deduction is limited to a percentage of the "tax EBITDA".

The financial charges are defined as the difference between deductible financial expenses (with third or related parties) after the application of the interest rate limitation (see above), and financial income received by a company.

The new law provides that financial expenses / income should now include interest on all types of debt (including capitalised interests included in the acquisition cost of an asset), interest paid under derivative instruments or hedging instruments such as swaps, fees paid in relation to guarantees, and bank administrative costs incurred in relation to a financing transaction (provided that these costs are taken into account for the calculation of the overall effective rate).

The "tax EBITDA" is defined as the taxable result subject to CIT at the standard rate, or the reduced rate of small and medium enterprises, before allocation of tax losses, rectified with the following amounts:

- net financial expenses;
- deductible depreciation, net of taxable reversals and of gains or losses on deducted depreciation;
- deductible provisions for depreciation, net of taxable reversals; and
- gains and losses taxable at reduced rates provided for by Article 219, I and IV of FTC.

The tax deductibility of net financial expenses would be limited to the highest of either:

- 3 million EUR; or
- 30% of the "tax EBITDA".

In presence of tax grouping, these thresholds are appreciated on the group level (and not entity by entity).

A safe-harbour provision is available for entities that are members of a consolidated group for financial accounting purposes. It allows an additional deduction equal to 75% of the net financial expenses not deducted pursuant to the above limitation, provided that the entity's equity-to-assets ratio is equal to or higher than the equity-to-assets ratio of the consolidated group.

These thresholds are substantially reduced in case of thin capitalisation (ie, when related debts exceed 1.5 times the equity). In this case, two bases will be subject to ATAD I rules with two different limits:

- “First Basis”: interest linked to non-related debt and related debt up to 1.5 times the equity;
- “Second Basis”: interest linked to related debt exceeding 1.5 times the equity.

Each basis will be subject to its own limit:

- “First Limit”: [nonrelated debt +(1.5 x equity)/total debt] to be multiplied by the general limit of 3 million EUR or 30% of EBITDA;
- “Second Limit”: [related debt - (1.5 x equity)/total debt] to be multiplied by the special limit of 1 million EUR or 10% of EBITDA.

Interest due according to the “First Basis” and exceeding the “First Limit” are not tax-deductible on the given fiscal year (FY) but may become deductible afterwards.

Interest due according to the “Second Basis” and exceeding the “Second Limit” are not tax-deductible on the given FY but may become deductible for one third of their amount afterwards.

The unused interest deduction capacity of a current tax year can be used over the following five tax years, but only against financial expenses incurred in those tax years. This measure is not available to thin-capitalised entities.

Anti-hybrid rules (ATAD II)

The French Finance Act for 2020 transposed into French law the rules arising from Directive EU/2017/952 of 29 May 2017 (ATAD II), focusing mainly on situations of double deduction and deduction without inclusion which would apply not only between EU Member States but also in situations involving third countries.

These new rules apply to financial years starting from 1 January 2020, with the exception of those relating to reverse hybrids, which will apply to financial years starting from 1 January 2022. Consequently, the former anti-hybrid measure applicable to interest (212, I-b FTC) has been repealed for FYs beginning on or after 1 January 2020.

The new ATAD II rules should apply between “associated entities” as defined under French law with two main direct and indirect thresholds (25% and 50% of voting rights, share capital, or rights to profits) and should apply depending on the type of hybrid mismatch at stake (ie, 50% for reverse hybrid). The new anti-hybrid rules also include a provision covering persons/entities acting jointly with another person/entities in order to be considered an associated entity.

New Articles 205 B, 205 C and 205 D of the FTC applies essentially to arrangements that are considered to be hybrids due to (i) their nature as instruments, or (ii) entities. These should give rise to asymmetries in tax treatment between two jurisdictions (deduction without inclusion, double deduction, imported hybrid, establishment income not taken into account and hybrid transfers intended to lead to WHT avoidance relief), reverse hybrid arrangements and dual residence issues.

Hybrid mismatch involving France will be settled pursuant to the following principles:

- Double deduction in France and in another EU or non-EU jurisdiction: the tax deduction should be denied in France;
- Deduction in France with no inclusion in another EU or non-EU jurisdiction: the tax deduction should be denied in France;
- Deduction in another EU or non-EU jurisdiction with no inclusion in France: the income payment should be included in the taxable base of the French payee.

Consequently, the charges deducted by companies operating in France in the context of cross-border operations must be analysed within the meaning of the new ATAD II rules. It will be necessary to study the treatment applicable both in France and in the beneficiary country in order to avoid non-deduction and penalties within the scope of ATAD II in France.

Withholding tax on interest

No WHT applies on interest paid to a foreign lender provided that such lender is not located in a non-cooperative country (in this case, a 75% WHT applies). The term “non-cooperative states or territories” (NCST) refers, under French tax law, to any state or country which does not comply with international measures against tax fraud and tax evasion.

A French Law dated 23 October 2018 introduced in the French definition of NCSTs (Article 238-0 A of the FTC) a reference to states which are included in the so-called EU ”blacklist” pursuant to one of the two following criteria:

- states that do not comply with the criterion relating to states or territories facilitating the creation of extraterritorial structures or arrangements designed to attract profits which do not reflect real economic activity ("extraterritorial criterion"); or
- states that do not comply with at least one of the other criteria defined in Appendix 5 of the conclusions adopted by the EU Council dated 7 December 2017.

However, in order to qualify as NCST from a French tax law perspective, a list of states and territories must be published by a decree. By Decree dated 6 January 2020 (published in the Official Journal on 7 January 2020), France updated its list of NCST, which now includes some states that are part of the EU "blacklist".

The new French list covers the following 13 states or territories: Anguilla, Bahamas, British Virgin Islands, Panama (since 2017), Seychelles, Vanuatu, Fiji, Guam, US Virgin Islands, Oman, Samoa, American Samoa, Trinidad and Tobago.

Finally, French tax law provides for several "safeguard clauses", allowing entities to avoid the application of certain restrictive measures if they can demonstrate that the transaction has a main purpose and effect other than to allow the revenues to be located in a NCST.

Remuneration of shareholders

Limited liability companies
After-tax profits distributed to its shareholders by a French limited liability company qualify as dividends. French-source dividends paid to non-resident individuals, whether paid in cash or in kind, are generally subject to the final 12.8% WHT. Lastly, the rate is 75% if dividends is paid to an individual resident of a non-cooperative states and territories.

Applicable tax treaties may however provide for a reduced rate or no taxation in France at all, where certain conditions are met.

In response to the European Court of Justice (ECJ) decision Denkavit rendered on 14 December 2006, the FTA have amended the tax treatment of the French source dividends paid to European companies (Administrative guidelines dated 10 May 2007). Accordingly, as of 1 January 2007, dividends paid by a French company to a European company benefit from a WHT exemption if:

- the parent company has held more than 5% of the share capital of the French company during a minimum two-year period; and
- the parent company cannot deduct the French WHT in its resident state.

The Finance Bill for 2016 incorporated this rule in the FTC.

Unlimited liability companies
Profits distributed to the shareholders of a tax look-through partnership-type vehicle, such as a SCI or SNC, are not treated as dividends and are not subject to French WHT on dividends.

Also, more generally, and regardless of the place of residence of the parent company, the mere ownership of shares in a French partnership vehicle does not constitute in itself a PE in France and, therefore, no branch tax liability is due in France in consideration for the profits repatriated. However, these issues need to be checked on a case-by-case basis.

Managing French real estate

Legal aspects

Management

Typically, an investor will engage an agent to deal with the collection of the rents and with the day-to-day management of the property.

The activity of purchase and resale of real estate property for third parties is governed by the French Loi Hoguet dated 2 January 1970, under which it is mandatory for any real estate agent or real estate asset manager to obtain a professional card from the French "*prefecture*". This card mentions the permitted activities of the holder and is delivered by the French authority, subject to specific conditions to be met by the applicant, such as:

- professional skills;
- financial guarantee;
- professional insurance; and

- civil conditions (no civil incapacity, interdiction measures, etc).

This card is delivered for a ten-year duration and can be cancelled at any time by the administration if the holder does not satisfy the above-mentioned conditions anymore.

This procedure does not apply if those activities are performed in a group of parent companies.

Commercial leases

Introduction

Commercial leases in France are, in principle, governed by a Decree (Law) dated 30 September 1953, which is now codified under Articles L. 145-1 et seq. and R. 145-1 et seq. of the French Commercial Code.

The statutory provisions give the tenant certain protection, in particular with regard to rent reviews and a so-called right of renewal or to obtain compensation if the lessor refuses to renew. But not all commercial leases benefit from these statutory provisions. Where the statutory provisions would not normally apply, it may be possible for the parties to contract into its provisions.

Conditions to be met for the statutory provisions to apply

To benefit from the statutory provisions, the requirements to be satisfied may be summarised as follows:

- The lease must be granted for a commercial, industrial or craft activity.
- The business must have been effectively carried out in the leased premises during a three-year period prior to the end of the lease or the date of renewal.
- The business must belong to the tenant.
- The tenant must be (whether incorporated or unincorporated) either registered at the Trade and Companies Registry or at the Arts and Crafts Registry for the premises in question. The registration must exist on the date on which (i) notice is given by the owner, or (ii) the application to renew is sent by the tenant to the landlord.
- The tenant must be a member of the EU or, if he is a French resident, must at least (since the Law dated 24 July 2006) hold a temporary residence permit authorising him to carry out a professional activity. If the tenant is not a French resident, a simple declaration to the French “prefecture” is sufficient.

The statutory provisions may also apply to leases of schools and some other cases.

Characteristics of a commercial lease

Term
Commercial leases must be granted for a minimum nine-year term, but the parties may agree on a longer period.

Leases granted for a term exceeding 12 years must be registered at the Land Registry (“*conservation des hypothèques*”) and so must be executed as a notarised deed. Due to the costs involved (cadastral tax) commercial leases for more than 12 years are very rare.

The tenant has the right to terminate the lease at the end of every three-year period subject to a six-month prior notice. But the tenant may also waive their right to terminate , particularly during the first period of the lease and agree to remain in the premises for the first six years, in the following leases: (i) Leases entered into for a term exceeding nine years and (ii) leases granted with respect to single-use premises (eg, hotels, clinics, cinemas, etc), office premises, or storage (warehouse) premises.

This is likely to be in consideration for accommodating a tenant’s request during negotiations, for instance, for a reduction in rent or a rent-free period or for a contribution towards the cost of the tenant’s fit out works.

Renewal
Under a statutory commercial lease, the tenant benefits from protected tenancy rights. It has a statutory right of renewal at the end of the lease. The landlord has the right to serve notice of non-renewal or refuse to renew a commercial lease, but this entitles the tenant to compensation from the landlord. The lease is renewed on the same T&C as the previous lease for another nine-year period unless the parties expressly agree on a longer term.

The lease may be renewed, even if the parties have not yet agreed on the amount of the rent of renewal.

If the parties remain silent after the expiry of the lease, it is automatically renewed for an undetermined term (all the other conditions of the lease remain the same). In this case, each party is entitled to terminate the lease at any time.

Rent
The rent is freely determined by the parties at the outset. For retail premises, it is not uncommon for the parties to agree for the rent to be calculated by reference to the tenant’s turnover, subject to a minimum annual rent (which

itself is usually set up at the market value). This now tends to be the rule in shopping centres and is becoming frequent in certain retail streets.

The rent is usually paid quarterly in advance or in arrears.

Indexation
In principle, the increase (or decrease) of the rent is capped by the variation of the statutory index selected by the parties, unless a change in the rental value exceeding 10% and triggered by a material alteration of the local commercial conditions can be demonstrated.

Until recently, indexed rents were usually adjusted in proportion to the variation of the national construction cost index, published quarterly by the National Institute for Statistics and Economic Studies (INSEE). Due to a substantial increase in the national construction cost index over the past few years, new indexes have been set up by the French Parliament: the commercial rents index (*indice des loyers commerciaux*, or ILC) for commercial premises and the tertiary activities rent index for office and warehouses premises (*indice des loyers d'activités tertiaires*, or ILAT).

Indexed rents can also be reviewed at any time if the rent has increased or decreased as a result of the indexation by more than 25% since the last date the rent was set (Article L. 145-39, Commercial Code). However, the resulting variation of the rent will not result in increases exceeding, each year, 10% of the rent paid during the past year

This index is applicable to all the new commercial leases or may be chosen by the parties at the renewal of the lease.

Guarantee
A landlord will invariably ask for some form of security. This may be a security deposit (equivalent to three- or six-months' rent). In this case, interest may be payable to the tenant if the amount of the rent payable in advance and the amount of the deposit together exceed six months' rent.

A bank guarantee, in the form of a statutory guarantee or a first-demand guarantee, is commonly required (this guarantee may be transferred to the purchaser of the property unless otherwise stipulated). A parent company guarantee may also be required.

Subletting
Prohibited, unless the lease provides otherwise.

Transfer of the right to lease
The lease generally prohibits assignments. However, a landlord cannot prohibit a tenant from assigning their lease to the purchaser of their business. But the lease may lawfully provide formalities to be complied with (eg, a requirement to inform the landlord in advance), or conditions to be satisfied (eg, the landlord to be satisfied that the assignee is solvent) to assign the lease to the purchaser of the business.

Permitted use
Such clauses are now standard. The tenant may not use the premises for any other activity than the activity described in the lease without obtaining the landlord's prior consent. The statutory provisions set out the procedure to be followed for extending the permitted use to ancillary activities, or to add to, or change the permitted use if the parties cannot agree.

Improvement of the premises
Usually, the landlord will have the contractual right to keep the tenant's improvements at the end of the lease without having to pay any compensation to the tenant. However, the landlord is entitled to require the premises to be reinstated in their initial status.

Determination of rent on renewal

The parties may freely determine the rent on renewal but the rent on renewal must correspond to the rental value of the premises.

If the parties do not agree, as is often the case, either party may apply to the court to fix the rent. The court will, in principle, apply the market rent. The following are taken into account in determining the market rent:

- the characteristics of the leased premises;
- the use for which the premises may be employed;
- the parties' obligations under the lease;
- local commercial factors that have an effect (positive or negative) on the business (these include the importance of the town, area or street where the business is located, the location of the business itself, the nature and whereabouts of the other businesses in the vicinity, the means of transport, the particular attraction of the location for the business in question, and permanent, durable or temporary changes to these factors);

- the current rents in the area.

If the lease to be renewed was granted for a nine-year term, the statutory provisions require the increase (or decrease) in rent to be capped.

If the rent is capped, the rent payable under the new lease cannot exceed the initial rent under the expired lease, as adjusted subject to indexation (see comments above) over the expired nine-year period. The rent payable under a new lease will, as a result, often be less than the market rent, and this can in the course of time add considerable value to a lease.

Capping will not apply if one of the parties can prove that, during the lease to be renewed, there have been substantial and significant changes to the premises, to their use, to the parties' obligations under the lease, or to the local commercial factors used to set the initial rent.

As an exception, the capping rules do not apply to the following situations:

- leases of land;
- leases of premises required to be used as offices only;
- leases of premises built for a specific single purpose (cinemas, hotels, clinics and theatres will often fall into this category);
- leases with a term of more than nine years or entered into less than nine years but having effectively lasted for more than 12 years (tacit renewal).

In the case of offices, the market rent will apply. For single purpose buildings, the rent is calculated essentially on the basis of a theoretical turnover derived from the number of seats or beds. The rules for land are also different, but it is essentially a market rent that will apply.

Compensation for non-renewal: eviction indemnity

As has already been mentioned, the landlord has no obligation to renew the lease.

If the landlord refuses to renew the lease of a protected tenant, she/he will be under an obligation to pay them an eviction indemnity, unless the tenant has failed to remedy a breach of a fundamental provision of the lease after a formal notice to remedy the situation has been served, or if the premises are about to be totally or partially demolished because they are considered by the authorities insalubrious or dangerous.

The purpose of the eviction indemnity is to compensate the tenant's loss suffered by the non-renewal of their lease.

The following will be taken into account to determine the amount of the eviction indemnity:

- the loss of business;
- the removal costs;
- relocation, moving expenses; and
- the price and costs relating to the acquisition of a similar business with an equivalent value

But the amount of the eviction indemnity may be reduced, if the landlord is able to establish that the tenant's loss is less than that determined by these factors.

If the parties are unable to agree, the courts determine the amount of the eviction indemnity.

Rent review

Both the tenant and the landlord are entitled to ask for the rent to be reviewed after at least three years have run from the commencement date or from the previous rent review. The new rent takes effect from the date on which one of the parties has made a proper request for the rent to be adjusted. The request must be made by a bailiff (*huissier*), or by letter sent by recorded delivery and must specify the new rent sought by the applicant.

If the parties fail to reach agreement on the new rent, the matter may be referred to the courts.

If it can be established that since the rent was last agreed or reviewed there has been a material change in the local commercial factors, which has alone caused the rental value of the premises to vary upwards or downwards by at least 10%, the judge will fix the rent according to the new rental value of the premises, applying the same criteria as those applicable for the determination of the rent on renewal. The new rent can theoretically be lower than the initial rent.

If, as is usually the case, there has not been any material change in the local commercial factors (or if the rental value of the premises has changed by less than 10%), the new rent will be capped, as the increase or decrease in the rent cannot exceed the variation of the ICC index over the same period. Furthermore, if there has not been any change in local commercial factors, the rent cannot be decreased, even if the rent is higher than the rental value.

It should be noted that in determining the market value of the premises, where relevant, the judge would, in practice, tend to rely on the report of the expert appointed by the court. In the absence of meaningful published figures, the appointed expert will deduce the appropriate rent from other decided rent review cases. Consequently, rents fixed judicially tend to be far less than the true market value. A situation is developing whereby judicially fixed "market rents" and open market rents are drifting apart.

The statutory rent review provisions are mandatory. The parties cannot, therefore, contract out of these. However, certain mechanisms are available to avoid these statutory provisions applying.

Professional leases

Leases of premises to a tenant carrying on a professional activity (for instance, doctors, lawyers, etc) are governed by the Civil Code and by Article 57 A of a Law of 23 December 1986. Professional leases must be granted for a minimum term of six years. The tenant has no right of renewal but has the right to terminate the lease at any time by giving at least six months' prior notice.

Tax aspects

Taxation of rental income

Corporate tax

Under current tax provisions, tax losses can be used as follows:

- The carryback of tax losses is limited to the FY in which the losses arise – any surplus would only be available for carryforward.
- The carryforward of tax losses is limited when the taxable result exceeds 1 million EUR. In this case and for the portion that exceeds 1 million EUR, companies are entitled to use tax losses to shelter only 50% of taxable profits (ie, CIT would be payable on at least 50% of the taxable result). Tax losses that were not used in a given year can be carried forward in their entirety (ie, there is no forfeiture of unused tax losses).

The taxable income is equal to the gross rental fees minus deductible expenses, both determined on an accrual basis such as (provided that they clearly relate to the French rental activity):

- employee costs;
- local taxes (eg, local real estate taxes);
- registration duty borne on the acquisition of the property which may either be fully deducted as an expense for the financial year in the course of which the acquisition was made, or be depreciated with the property over the useful life of the property;
- irrecoverable VAT, ie, VAT borne on purchase of services, or goods that are related to a non-VATable activity;
- other general expenses such as management fees and insurance premiums;
- interest on a loan contracted in order to purchase and/or refurbish the French property (subject to limitations on related party loans);
- depreciation allowances (excluding the land element, which is non-depreciable) provided that they are recorded in the accounts.

Since 1 January 2005, French generally acceptable accounting principles (GAAP) have been amended, and therefore, rules governing depreciation of buildings have been changed. Permanent assets are to be split into components and depreciated accordingly. Main structure and elements subject to replacement at regular intervals, having different uses or providing the company with economic benefits and following different rhythms, require proper rates and depreciation methods, eg, for a building, structure/elevator/plumbing are depreciated over the life duration of each of these components. However, the FTA admit that the structure can be depreciated based on the standard rates provided in administrative guidelines before 2005 (ie, depreciation rate between 2% and 5% for commercial premises, 4% for offices and 5% for industrial facilities/warehouses).

The depreciation of the property has a direct negative impact on the capacity of the company to distribute dividends: the accounting result may be lower than the amount of available cash. Consequently, should the shareholders have minimum cash repatriation requirements, it is necessary to identify other means for repatriation of the excess cash, eg, shareholder loans and/or share premiums that can be easily reimbursed.

For properties held by a look-through entity (such as an SCI, or SNC), the deductible depreciation charge can be limited by the amount of the net rental income generated by the property (difference between the rents and all the property-related costs, interest included).

Personal income tax

Non-treaty-protected individuals owning a property in France without renting it out on an “arm’s length” basis, are subject to personal income tax based on three times the rental value of the property. Tax treaty protected individuals are not subject to this minimum taxation and are only taxable in France if they let their property.

Non-French individuals who rent out their French property are subject to French income tax on rentals.
In accordance with domestic rules, the taxable income is equal to the rental income (including expenses that are paid by the tenant, but which should have been borne by the landlord) minus deductible expenses such as (provided that they clearly relate to the French property):

- repairs, maintenance and improvements (other than construction expenses);
- employee costs;
- local taxes;
- managing agent’s fees;
- insurance premiums for loss of rents;
- interest on a loan contracted to finance the purchase and/or refurbishment of the French property (provided that the property is rented to a third party).

Registration duty paid upon the acquisition is not tax-deductible from rental income. It is deductible from any taxable capital gain generated by the sale.

Real estate losses, excluding those generated by interest charges, can be set off against the landlord’s other taxable income up to 10,700 EUR and carried forward over six years. Real estate losses exceeding 10,700 EUR threshold or resulting from interest charges can be set off against rental income only over a ten-year period.

VAT on rents and rental tax

The letting of furnished or unfurnished lettings for dwelling purposes is, in principle, exempt from VAT, but subject, if the building is over 15 years old, to a rental tax at the rate of 2.5%, which is levied on the annual rental income.

The letting of furnished professional premises and parking lots is liable to VAT at the standard rate of 20%.

Finally, the letting of unfurnished professional premises is, in principle, exempt from VAT and subject to the 2.5% rental tax. The lessor can, however, elect for VAT within 15 days after the beginning of the rental activity (in such a case, rents are exempt from the rental tax).

A VAT election is valid until it is revoked. It has to be made building by building and is possible when the tenant is liable to VAT and uses the building for its commercial activities – the VAT election is also possible when the tenant is not subject to VAT (eg, an administration that will use the building for its administrative activities), but in such a case, the VAT election must be expressly stated in the lease contract.

The 3% annual tax

Scope
French or non-French entities, with or without legal personality, including trusts and similar vehicles, owning either directly or indirectly (and whatever the number of companies interposed between the building and the ultimate shareholders) real estate properties located in France, which do not perform a professional activity other than a rental one, fall within the scope of a 3% property tax. This tax is levied annually and is based on the fair market value of French real estate property owned as at 1st January.

Moreover, according to FTA guidelines, entities filing 3% tax returns must, if requested, provide the FTA with supporting documentation in order to confirm the identity of its investors/ stakeholders, their addresses and the number of units held. Such documentation includes (but is not limited to):

- corporate formation and governance documents filed with the courts or public services of the state or territory in which the entity resides, such as an extract from the Company Registry or Register of Commerce or equivalent, articles of association, corporate registration information imposed by the corporate law of the country concerned, shareholder minutes or other minutes of meetings of management bodies, minutes of general meetings, board of directors or supervisory board, etc);
- statements or information returns filed with the tax authorities of the state or territory of residence of the entity when they provide such information;
- documents authenticated by a member of a regulated profession recording the distribution of shares and movements of securities (registers of registered or movement securities), as well as any evidence relating to financial movements related to the sale or acquisitions of securities, capital increases or reductions;

- any other official document issued by a foreign administration or government specifying the identity and address of the shareholders or unit holders and the number of shares or rights held, including the shareholder's passport or identity card.

To provide the requested confirmation, a confirmation letter has to be prepared and signed by the General Partner/Manager. The FTA have retained the right to ask for additional documentation.

Exemptions
The 3% annual tax does not apply to:

- sovereign states, public bodies and entities with or without legal personality held for more than 50% by a sovereign state or a public body.
- entities with or without a distinct legal personality (including trust and similar entities) owning directly or indirectly real estate properties located in France where the fair market value is below 50% of the total value of the French assets held directly or indirectly by the entity. The French properties that are allocated to a professional activity (other than a pure real estate activity) are not included for purposes of computing the 50% ratio, including where the professional activity is carried out by a related party.
- entities with or without a distinct legal personality (including trust and similar entities) where the stocks are admitted to negotiation on a regulated market and are regularly and significantly traded and their wholly owned subsidiaries (held directly or indirectly).
- The following entities with or without separate legal personality (including trusts and similar entities) having their registered office in France, in an EU Member State or in a country that has concluded a DTT with France that includes an administrative assistance or a non-discrimination clause:
  - entities owning directly or indirectly French properties, where the share ownership value in said French properties does not exceed either 100,000 EUR or 5% of the fair market value of the French properties.
  - pension funds (or charities publicly recognised as fulfilling a national interest) whose activity supports the need to own French properties.
  - non-listed French open-ended real estate funds (SPPICAV and FPI) and foreign funds subject to equivalent regulations.
  - entities that file each year by 15th May or undertake to disclose to the FTA at first request, information on shareholders owning more than 1% of share capital. The undertaking to disclose must be filed in principle upon the acquisition of the French property or upon the acquisition of a stake leading to indirect ownership in French properties.
  - entities that file every year by 15th May, information on shareholders (owning more than 1%) about whom they have detailed information.
  - In all cases, foreign entities must be able to produce tax residency certificates proving that the local tax authorities consider that they are genuine tax residents.

Consequently, the use of entities located in either tax haven countries or which are excluded from tax treaty benefits (or which do not wish to reveal the names of their own shareholders) in order to hold directly or indirectly buildings located in France must be avoided. Otherwise, the 3% annual tax will be due.

It should be noted that the FTA have stated that companies that have failed, in good faith, to file the required documentation, but which could otherwise have benefited from an exemption, may regularise their situation vis-à-vis the 3% annual tax either spontaneously or upon request, without incurring the risk of having to pay the tax.

Tax on real estate property

Article 31 of the 2018 finance bill removed the wealth tax (ISF) in place in France since 1982 and replaced it with a tax on real estate property (IFI) as from 1 January 2018.

The IFI applies to real estate assets held in direct or through the intermediate of a chain of shareholdings (with several conditional exemptions available).

French tax residents are subject to the IFI on the fair market value -as of 1 January of the relevant year - of their real estate assets held in direct or through the intermediate of a chain of shareholdings situated in France and outside France (up to the value representing taxable real estate assets). Non-French tax residents are subject to the IFI under the same conditions on the sole basis of their French based real estate assets; according to a progressive scale ranging from 0.5% to 1.5% after a EUR 800,000 allowance, if the net value of their taxable assets exceeds EUR 1,300,000

In addition, individual taxpayers who have not been domiciled in France during the five years preceding the transfer of their domicile to France are only taxed on their property located in France, until 31st December of the fifth year following the year of arrival in France.

Property or rights subject to usufruct remain included in the assets of the beneficiary of usufruct for the whole amount of the full property value. The law does however provide for an exception related to dismemberment of property created in virtue of the legal usufruct of the surviving spouse under Article 757 of the FTC; in this case, which is frequent in practice, the beneficiary of usufruct and the bare owner are each taxed on their respective share which is determined according to the usufruct tax rate bands of Article 669 of the FTC.

The deductible passive expenses of the IFI's base are limited to the taxes related to the taxable real estate property (ie, real estate tax notably), excluding income tax.

Another restriction related to the deductibility of finance debts related to the property subject to the IFI should be highlighted: "in fine" loans are only deductible according to an annual amortisation coefficient, in order to limit the fiscal advantage obtained in the context of certain real estate acquisition schemes using debt.

As a consequence, only the sum of the annuities corresponding to the number of years left before the end of the contract is deductible.

Regarding intra-family loans and those contracted with companies related to the taxpayer, they are excluded from the deductible passive expenses.

A general ceiling applies to the deduction of debt when the value of the taxable assets exceeds five million euros and when the amount of debt is more than 60% of this amount; the amount of debt exceeding this threshold is only deductible up to 50% of the excess.

The IFI declaration will be done by the taxpayer by indicating the gross value and the net value of assets on the income tax return form 2042 and by providing the details of the taxable assets on annexes to be included.

The IFI will be collected via the issuance of a bill (at the end of August or beginning of September).

Business tax

As of 1 January 2010, the business tax has been replaced by the so-called "*contribution économique territoriale*" (CET). CET consists of two elements: (i) the "*cotisation foncière des entreprises*" (CFE), assessed on the rental value of properties, and (ii) the "*cotisation sur la valeur ajoutée des entreprises*" (CVAE), computed on the basis of value added.

CVAE
CVAE is due by companies performing an activity on 1 January of each taxable year and is based on the value added of the company according to a specific calculation defined by French tax regulations.

CVAE tax rate is between 0% and 1.50% (progressive rate) and is determined, as follows, according to the turnover of the company. Specific rules apply when the entity meets the holding percentage requirement to be part of a tax group, (ie, more than 95%) in order to aggregate the turnovers of the entities of the group located in France.

CVAE declaration needs to be filed electronically on the 2nd business day following 1 May whenever the turnover exceeds 152,500 EUR. CVAE must be paid spontaneously in two instalments (mid-June and mid-September) and the balance in May of the following year.

CFE
CFE is due by companies performing an activity on 1st January of each taxable year and is assessed on the rental value of owned or leased premises.

CFE is a local tax and so the rates vary. A minimum CFE amount is determined by the territorial authorities.

A CFE tax notice is posted on the company's www.impots.gouv.fr account on the 16th November of the taxable year at the latest. The contribution must be paid through the FTA website on 15th December. If the CFE of the previous year exceeds 3,000 EUR, an instalment (50%) is due on 15th June.

Local real estate taxes (rates)

The two main local taxes are the dwelling tax (*taxe d'habitation*), payable by the individual who disposes of a furnished residential property, and the real estate tax (*taxe foncière sur les propriétés bâties*), payable by the real estate owner. Generally, leases will provide that the tenant is to reimburse the landlord the *taxe foncière*. The "*taxe d'habitation"*, in the case of residential leases, is borne by the occupant.

Both taxes are based on the cadastral rental value of the property (which is lower than its real rental value) and their rates are fixed, on a yearly basis, by the local authorities.

Tax on ownership of office premises, commercial premises and warehouses

The tax on the ownership of office premises, commercial premises and storage space in the Paris area (*taxe annuelle sur les locaux à usage de bureaux, les locaux commerciaux et les locaux de stockage en Ile-de-France*) is due annually by the owner of buildings (this tax, which is not deductible from the taxpayer's income, is often recharged to the tenants).

For office premises, the amount of tax varies from district to district from 4.64 EUR to 23.18 EUR per square metre (office premises under 100 square metres are exempt from this tax). For commercial premises, the tax varies from district to district from 2.08 EUR to 7.94 EUR per square metre (commercial premises under 2,500 square metres are exempt from this tax). For warehouses, the amount of tax varies from district to district from 1.07 EUR to 4.12 EUR per square metre (commercial premises under 5,000 square metres are exempt from this tax).
For parking spaces, the amount if tax varies from district to district from 0.72 EUR to 2.61 EUR per square metre.

The tax on ownership of office premises are not deductible from CIT purposes.

Also, additional annual tax on parking space in Ile-de-France (*taxe annuelle sur les parkings en Ile-de-France*) is due. This tax varies from district to district from 1.31 EUR to 4.47 EUR per square metre. For commercial parking spaces, reduced rates apply (ie, from 0.66 EUR to 2.24 EUR per square metre).

Sale of French real estate

Legal aspects

The sale of the investment must be carefully examined beforehand, as the methods used to dispose of a real property may totally differ from the methods used to purchase it (direct sale of property or sale of shares of the entity that owns the property)

The various investigations sought by the buyer will be made during a due diligence process and preparatory stage. During this stage, the unilateral or reciprocal commitment of sale or the agreement of sale (*promesse unilaterale ou synallagmatique de vente*) and other preliminary contracts will need to be executed, and once again, because they are time-consuming, they should be prepared in advance if a given deadline needs to be met for the implementation of the disposal.

Seller will mainly be protected via means of securing the total payment of the price, which is deemed net of any fees and expenses that are supposed to be borne by the buyer.

There is no warranty provided by the seller except for the declarations and representations mentioned in the notary deed (ownership, etc) and mandatory legal warranties.

Tax aspects

VAT and registration duty

As previously mentioned, the sale of real estate and/or shares of real estate companies are subject either to VAT or to registration duty calculated on the price, or the value of the shares, if higher.

Taxation of capital gains

In principle, based on French domestic tax provisions, any non-resident is liable to a WHT on capital gains arising from the sale of either real estate in France or the shares in a real estate company whose assets mainly consist of French properties.

This WHT will not be levied if it can be considered that the investors carry out a business in France and use the real estate for the purpose of their business (a mere rental activity will not be eligible).

However, the application of this WHT will mainly depend on the provisions of the relevant tax treaty since some of them do not attribute to France the right to tax such capital gains, but this exclusion mainly concerns the sale of real estate company shares.

Sale by non-resident companies

If France has the right to tax the gain, a withholding will be levied, the said WHT being deductible against the company's liability to corporate tax in France, and any excess WHT is refundable.

Sale of the real estate

For the purposes of the WHT payable by a company, the taxable capital gain is equal to the difference between the sale price and the purchase price. The rules differ depending on the country of residence of the company.

If the company is located in the EU, Iceland and Norway, the rules to determine the taxable capital gain are the same than the ones applicable to French resident companies.

Otherwise, the taxable capital gain is reduced by 2% per year of ownership (this 2% reduction only applies to the portion of the acquisition price of the buildings, ie, excluding the land).

The net capital gain will be subject to a WHT at the standard CIT rate. If the sale is made by a French pass-through entity (ie, SCI or SNC), net capital gain would also be subject to CIT at standard rate plus additional contribution (if applicable). WHT would be off set against CIT due (but not the additional contribution).

The WHT must be paid when the notarised deed of conveyance is filed at the Land Registry and the FTA. The notary will collect the tax from the seller. An accredited French tax representative must be appointed in order to file a tax return and pay the tax on behalf and in the name of the seller. The transfer of the real estate is subject to the payment of the WHT.

Sale of the shares in a real estate company

The taxable basis is equal to the difference between the sale price and the purchase price of the shares.

The net capital gain will be subject to WHT at the standard CIT rate as well as CIT at standard rate plus additional contribution (if applicable). WHT would be off set against CIT due (but not the additional contribution).

If the real estate company is a French SARL or SCI, the sale of its shares must be filed with the Commercial Registry which, in practice, may refuse to register the sale if, beforehand, the seller has not succeeded in having the share transfer agreement registered with the FTA.

Sale of the shares in a SIIC or a listed real estate company

The sale of the shares in a SIIC or a listed real estate company on regulated French or foreign market is subject to a 28% capital gain tax (progressively reduced to 26.5% in 2021 and 25% in 2022) if the seller holds directly or indirectly at least 10% of the share capital of the company where the shares are transferred. If the seller is an EU tax resident, the WHT rate is decreased to 19%.

Sale by non-resident individuals

If France has the right to tax the gain, the WHT is paid in full and final settlement is made of all tax due in France on the gain made by the non-resident.

The below described regime applies to the sale of:

- real estate;
- shares in in a tax transparent real estate company;
- shares in real estate company subject to CIT;
- shares in a SIIC, a listed real estate company or a SPPICAV.

The capital gain is equal to the difference between the sale price and the purchase price.

In the sole cases of a direct sale of the property by the non-resident individual or the disposal by a French transparent entity held directly by a non-resident individual, the capital gain is increased by (i) the acquisition costs effectively borne (or set at 7.5% of the acquisition price), and (ii) the real cost of all the improvement and maintenance works carried out (or set at 15% of the acquisition price if the real estate has been held for more than five years).

The gain is reduced by 6% per year between the 6th and 21st year of ownership and 4% for the 22nd year. Accordingly, after 22 years of ownership, there is no WHT payable on the gain. Capital gains may also benefit from exemptions such as the capital gains tax exemption applying to sales of French residences of non-residents upon specific conditions.

If the seller is an EU tax resident, the net capital gain will be subject to a 19% capital gain tax (same rate as for a French resident), while if the seller is a non-EU tax resident, the net capital gain will be subject to the standard CIT rate except when the seller is located in a non-cooperative state or territory (Anguilla, Bahamas, British Virgin Islands, Panama (since 2017), Seychelles, Vanuatu, Fiji, Guam, US Virgin Islands, Oman, Samoa, American Samoa, Trinidad and Tobago) where the rate is 75%.

The effective rates of taxation are the following:

- As of 1 January 2016, capital gains realised by non-resident individuals upon the transfer of real estate property in France are subject to social security contributions (CSG/CRDS). Indeed, as a result of the condemnation of France by the ECJ regard to the implementation of the liability of non-residents to social security contributions (as from 17 August 2012), the Financial Act for 2016 re-introduced this provision which is now in accordance with the EU law. As result the effective WHT rates currently are 36.2% (19%+17.2%) or 92.2% (75%+17.2%);
- As of 1 January 2013, a surtax on real estate capital gains greater than 50,000 EUR on sales property applies to non-resident individuals (between 2% and 6% depending on the amount of taxable capital gains) so that the effective taxation rate will be:
  - between 36.2% and 42,2% if the seller is an EU or non-EU tax resident;
  - between 92.2% and 98,2% if the seller is located in a non-cooperative country.

This surtax does not apply to capital gains benefitting from an exemption as property hold for more than 22 years or residence in France of a non-resident.

Sale by a French limited liability company

Sale of the real estate

The taxable capital gain, usually equal to the difference between the sale price of the building and its net book value, is taxed at the standard CIT rate (increased by the surtaxes). Clearly, there is a full clawback of the depreciation allowances previously deducted.

Sale of the shares in a non-listed real estate company

The capital gain, usually equal to the difference between the sale price of the shares and their net book value, is taxed at the standard CIT rate.

Sale of the shares in a listed real estate company

The capital gain, usually equal to the difference between the sale price of the shares and their net book value, is taxed at the standard CIT rate or at the reduced tax rate of 19% if the seller has held at least 10% ownership for at least two years.

Inheritance and gift tax

Under French domestic law, a non-resident individual who directly or indirectly owns real estate in France is liable to French inheritance and gift tax on that property (tax rates, which vary according to the kinship existing between the deceased/donor and the beneficiary and the amount of the gift, range from 5% to 60%). The indirect ownership test is met either when an individual owns shares of a company, whether French or not, whose assets consist, directly or indirectly, mainly of real estate in France or, where the interposed company's assets do not consist mainly of real estate in France, if the individual, together with his/her spouse, parents, children, sisters and brothers, holds, directly or indirectly (regardless of the number of interposed legal entities or organisations) at least 50% of the capital of a legal entity or organisation owning real estate property in France.

The application of these provisions will, of course, depend on the terms of any applicable tax treaty for the avoidance of double taxation on inheritance and gifts. However, very few tax treaties deal with gift tax issues.

The inheritance or gift tax will be levied on the value of the property, if it is held directly, or on the value of the shares, if the real estate is owned through a company.

F-REIT or sociétés d'investissements immobiliers cotées (SIIC)

Main tax rules

A specific tax regime is offered to listed real estate companies (*sociétés d'investissements immobiliers cotées*).

By virtue of said provisions, companies, whose main activity is the leasing of properties as well as the subletting of properties under certain circumstances, which have a share capital at least equal to 15 million EUR and are listed on a French regulated market or on a foreign stock market, which meets the requirements set forth by the EC Directive 2004/39/EC dated 21 April 2004, can, together with their subsidiaries (subject to CIT) held at more than 95%, elect for the regime provided for by Article 208 C of the FTC, whereby, said companies are exempt of CIT on: (i) their rental income (or the rental income realised by their tax transparent subsidiaries); and (ii) the capital gains triggered by the sale of their properties (or the properties owned by their tax transparent subsidiaries),

or the sale of the shares of their subsidiaries; and (iii) the dividends received, provided the following conditions are met:

- At the time of the election for this tax regime, 19% exit tax is paid on any latent gain existing on their real estate assets or on the shares of their tax transparent subsidiaries (the payment of said exit tax being in fact spread over a four-year period).
- At least 95% of the tax profits deriving from the rental income realised by the company, which has elected for the SIIC regime (and by its tax transparent subsidiaries), must be distributed before the FY of their realisation ends.
- At least 70% of the tax profits deriving from the sale, by the company, which has elected for the SIIC regime (and by its tax transparent subsidiaries), of buildings or real estate companies shares, must be distributed before the end of the FY following the FY of their realisation.
- 100% of the tax profits deriving from the dividends received by a company, which has elected for the SIIC regime (and by its tax transparent subsidiaries) from a subsidiary itself subject to the SIIC regime or from another listed SIIC held for at least 5% since at least two years, must be distributed before the FY of their reception ends. The Finance Bill for 2008 extended the exemption to dividends received by a SIIC from a SPPICAV or a foreign company that has a similar statute to a SIIC, provided that the SIIC that received the dividends holds at least 5% of the share capital of these entities for at least two years.

Opportunities offered by the regime

In 2019, there were around 24 French SIICs.

Whether or not an existing company and its subsidiaries can elect and/or have an interest to elect for such a regime is to be reviewed taking into account the following elements:

- The dividends distributed out of the exempt profits will not benefit from the EU Parent-Subsidiary Directive. Therefore, non-French shareholders may be subject to 28% WHT (progressively reduced to 25% by 2022) at source on the dividends received (said rate may be reduced by the relevant tax treaties).
- Because the companies that elect for this tax regime cease to be fully subject to CIT, the election to the said tax regime could entail significant tax consequences, such as the termination of an existing tax group, which could induce costly tax consequences;
- The business plan of the group vis-à-vis its French portfolio;
- The level of tax liability on latent gains, which has already been booked by the group in its consolidated balance sheet, etc.

Since 1 January 2010, it is possible for SIIC to set up joint venture (JV) entities with OPCI (see section "*OPCI*" below). In other words, the SIIC regime is now available to French subsidiaries that fulfil the requirements to elect for the SIIC regime, subject to CIT, that are at least 95% held by one or several SIICs or one or several SPPICAVs or jointly held by one (or several) SIIC and one (or several) SPPICAV.

The anti-captive provision

As of 1 January 2010, the financial and voting rights in a listed SIIC must not be held, directly or indirectly, at any moment during the application of the SIIC regime, at 60% or more, by one or several shareholders acting jointly ("*action de concert*"). In principle, where this ratio is not met, the tax-free regime will not apply in the future (definitive exit). However, under certain circumstances, the tax-free regime can only be suspended for a given financial year (temporary exit).

In addition, a minimum 15% free float needs to be respected (free float being defined as a maximum of 2% per shareholder).

The "anti-Spanish" route provision

SIIC dividends paid to French corporations are fully subject to CIT, whereas SIIC dividends paid to a Spanish parent company may not be subject to any tax in France and in Spain. This distortion has created a certain level of emotion. Accordingly, for dividends distributed as of 1 July 2007, SIICs are subject to 20% tax on distributions made to shareholders (other than individuals) owning, directly or indirectly, 10% of the share capital, where said shareholders are not subject to CIT on their SIIC dividends, or are subject to CIT for an amount lower than one-third the amount of CIT, which would have been paid in France. The tax is equal to 20% of the dividends paid, before WHT if any. This provision does not apply where the shareholder of the SIIC is a SIIC vehicle or a foreign company with similar status, ie, with a full distribution requirement, and provided that the shareholders of the said intermediate vehicles own at least 10% of the share capital, would in turn be taxable on subsequent distributions.

The 20% tax is presented as an autonomous tax, but is assessed and collected as CIT. The compatibility of the 20% tax with EU legislation and existing DTT is still being evaluated. One could follow up on how the 20% tax would apply to distributions made to French pension funds, which traditionally are tax-exempt on French source dividends.

OPCI (French non-listed REITs)

French law provides a regulated real estate investment vehicle, called "*organisme de placement collectif en immobilier*", or OPCI.

The OPCI regime is available through two alternative vehicles, which are the "*fonds de placement immobilier*", or FPI, having no legal personality (tax transparency) and the "*société de placement à prépondérance immobilière à capital variable*", or SPPICAV, which has a legal personality (subject to CIT).

OPCI have to be at least 60% invested in real estate properties and must comply with LTV ratio granted by the AMF (usually between 70% and 80% maximum). Moreover, SPPICAV may not exceed 9% maximum investment in real estate listed companies and may benefit from a CIT exemption available if 85% of rental income and 50% of capital gains are distributed.

Regulatory issue has to be managed with the AMF.

Tax aspects of SPPICAV

SPPICAVs benefit from a CIT exemption on the entirety of their income/capital gains.

Dividend distributions from SPPICAVs to companies subject to CIT do not benefit from the parent/subsidiary exemption on dividends and are taxed at the standard CIT rate. Capital gains are subject to CIT.

Distributions from SPPICAV to French individuals are treated as dividends. They are subject to 30% flat tax (comprised of the 12.8% personal income tax and 17.2% social contributions) upon their payment to the French individual or at the taxpayer's option, to the personal income tax progressive rates (of up to 45%) accrued by 17.2% social contributions.

As from 1 January 2013, capital gains (after the application in certain cases of a tax allowance for holding period) on the repurchase of shares are subject to 30% flat tax (comprised of the 12.8% personal income tax and 17.2% social contributions) or, at the taxpayer's option, to the personal income tax progressive rates (of up to 45%) accrued by 17.2% social contributions.

French non-resident individuals are subject to 12.8% WHT on dividends. Regarding the capital gains, these are subject to a levy in discharge of income tax of 19%. Social contributions also apply.

Retail SPPICAVs benefit from a 3% tax exemption.

The conversion of a company subject to CIT into a SPPICAV benefits from a reduced 19% CIT rate on the latent gains existing on real estate assets (the payment of this tax being in fact spread over a four-year period).
The shareholders of the company transformed are not taxable on the surplus on a winding-up.

Tax aspects of FPI

Rental income collected by FPI (directly or not) and capital gains realised are taxed at the shareholders' level.

Shareholders subject to CIT are taxed at a standard rate on these gains.

FPIs attribute mainly rental income and capital gain on real estate that are taxed in France the same way that if the non-resident individual had realised the same income directly. Please refer to our comments above.

Individual French tax resident shareholders are subject to income tax on rental income and taxed at progressive rates (of up to 45%) accrued by 17.2% social contributions. Capital gains are subject to 19% tax accrued by 17.2% social contributions.

Non-residents are subject to WHTs on dividends (28% for companies and 12.8% for individuals), and capital gains (28% reduced rate may apply subject to the application of DDTs).

Retail FPIs benefit from the 3% tax exemption.

Furthermore, the transfer of OPCI shares is exempted from registration taxes, except in certain cases where 5% transfer tax is levied, when, following the acquisition:

- an individual holds (directly or indirectly) more than 10% of the OPCI shares;
- a legal entity holds (directly or indirectly) more than 20% of the OPCI shares.

The Amended Finance Bill for 2007 extends this exemption from registration taxes to the repurchase of OPCI shares in the case where the re-purchaser is itself an OPCI (subject to both exceptions above).

The Finance Bill for 2010 has amended the SIIC and the OPCI regime in order to facilitate the setting-up of JV entities between SIIC and OPCI.

Municipal taxes

There are four main taxes that depend on French local government (regions, departments and municipalities), which are as follows:

- business tax;
- real property tax on undeveloped land;
- real property tax on buildings; and
- habitation tax.

Business tax

As of 1 January 2010, the business tax has been replaced by the so-called "*contribution économique territoriale*" (CET). CET consists of two elements: (i) the "*cotisation foncière des entreprises*" (CFE) assessed on the rental value of properties, and (ii) the "*cotisation sur la valeur ajoutée des entreprises*" (CVAE) computed on the basis of value added.

The CVAE should be payable by the landlord of the property that is let, and the landlord will be taxable based on the value added derived from the rental activity. CVAE will be payable by the landlord of the property if their turnover exceeds 500,000 EUR.

The CVAE has a progressive rate going from 0.5% for turnover of 500,000 EUR up to 1.5% for turnover exceeding 50 million EUR. For determination of the progressive rate purposes, a company which fulfils the group conditions (Article 223 A of FTC) has to take into account the turnover of the tax group.

CFE is due by companies performing an activity on 1st January of each taxable year and is assessed on the rental value of owned or leased premises. CFE is a local tax and so the rates vary.

Real property tax and habitation tax

Property tax and habitation tax are based on the real estate rental value of developed land and undeveloped land, according to specific returns filed by the owner of related properties.

The rental value is computed by the real estate tax administration, and is used to compute property tax, habitation tax and part of the business tax.

Owners of properties used for habitation are liable for real estate tax on a real estate rental value basis, computed by the French real estate tax administration, according to a square metre value (EUR/square metre).

Users of habitations are subject to habitation tax on the same real estate rental value as for real estate tax, but with specific rules and some reductions/exemptions, according to the tax status of inhabitants.

Properties used by entities subject to CIT and performing a commercial activity are liable for real estate tax on developed and undeveloped land on a real estate rental value basis, computed by the French real estate tax administration, according to a square metre value (EUR/square metre).

Properties used by entities that are performing industrial activities are subject to real estate tax on developed land and undeveloped land on the real estate rental value basis, computed by the French real estate tax authorities, according to the gross book value of the immoveable assets.

The real estate rental value is to be modified on 1 January of each year following an addition/removal of building. Then, any square metre increase/decrease induces an increase/decrease of the real estate rental value for commercial buildings, and any addition/removal of assets should normally be declared to the tax authorities (by the lesser or even the lessee).

Tax rates are levied for the benefit of the regions, departments and municipalities (ie, public entities that have administrative and taxing powers), so the global property tax rates are then very different from one site to another.

Miscellaneous taxes

Other miscellaneous taxes linked to real estate are levied for the benefit of local governments, such as the following:

- registration duties on transfer of real estates;
- duties for use of public streets/places;
- mining fees;
- accommodation fees; and
- garbage cleaning fees

In addition, several additional municipal taxes have been recently introduced (*taxe d'aménagement et du versement de sous-densité*) or extended and should therefore be carefully considered before implementing any investment in France.

Conclusion

It will be clear from this introductory guide that any real estate investment in France has to be considered carefully, both from a legal and tax aspect, to make the investment more efficient.

The choice of the proper vehicle for the acquisition will take into account the following factors:

- the tax impact of the registration duties to be paid both at the time of the purchase and on resale;
- the possibility of reducing the level of payable tax on the rental income (via indebtedness for instance);
- the cash-flow repatriation and the applicable WHT;
- the ways of managing the 3% annual tax;
- the possibility of reducing the future taxation of the capital gains on the resale of the property or of the real estate company.

The most suitable structure will vary from one investment to another, depending on the investment profile, the investor, the country of origin and the envisaged exit plan.

Even if a "one-size-fits-all" target is often sought, we do believe that only tailored structuring will fully fit one's goals and perhaps allow for those tax and legal opportunities that can, sometimes, be one of the competitive advantages of a deal.

An investor, whether French or foreign, would be well advised to seek professional advice from local advisers from the very beginning of a deal.

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Real Estate Going Global

Germany

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

Overview

Real estate investors regularly consider taxes in their yield planning. Although the tax level in Germany is comparatively high, the structure of an investment (eg, the legal form of the property holding company, financing structure, application of the double tax treaty) will have an impact on the effective taxation of a real investment. Investors' knowledge of the German tax system and the double tax treaty (DTT) compared with their respective home country is indispensable for making optimal use of tax-structure options.

The following summary of the key aspects of the German tax regime that apply when investing in German real estate focuses on two types of investor: the professional real estate investor who invests via corporate vehicles in German real estate, and certain types of individuals as real estate investors. Only the general principles are outlined. The subsequent (non-exhaustive) sections give investors an overview of the most important taxes in connection with an investment in German real estate in order to determine the tax exposure throughout the lifetime of the real estate investment. These are in particular:

- income tax and corporate income tax (CIT);
- trade tax;
- withholding taxes (WHT);
- value-added tax (VAT);
- real estate transfer tax (RETT); and
- land tax.

It should be noted that throughout this document, the term "corporation(s)" is used to refer to the German term *Kapitalgesellschaft(en)*, the term "partnership(s)" to *Personengesellschaft(en)*, and the term "company/-ies" generally to *Gesellschaft(en)*, ie, to both (or either of) corporations and partnerships.

For more detailed aspects of the acquisition, the construction and the sale of German real estate as well as the investment in German real estate via fund vehicles, please see section "*Real Estate Investments*".

Income tax (*Einkommensteuer*) and corporate income tax (*Körperschaftsteuer*)

Resident companies and individuals

German income taxation depends mainly on the status of the taxpayer as well as on the category of income derived from an activity.

Partnerships do not constitute a taxable entity for income tax purposes; their income is attributed directly to its partners and taxed at their level under the Income Tax Act (*Einkommensteuergesetz*) or Corporate Income Tax Act (*Körperschaftsteuergesetz*). However, a partnership is a taxable entity for trade tax purposes. Legal entities, in particular corporations that have their seat or place of management in Germany, are subject to German CIT on their worldwide income ("unlimited tax liability").

German income tax law differentiates between seven categories of taxable income. For real estate investments, the differentiation between "business income" (*Einkünfte aus Gewerbebetrieb*) and "rental income" (*Einkünfte aus Vermietung und Verpachtung*) is of particular relevance.

Income is classified as "business income" either by statutory definition or by business activity.

Most corporations, in particular the limited liability company (*Gesellschaft mit beschränkter Haftung*, or GmbH), or public incorporated company (*Aktiengesellschaft*, or AG), derive "business income" by statutory definition regardless of whether their actual activities can be characterised as a business activity. Partnerships such as the general partnership (*Offene Handelsgesellschaft*, or OHG), limited partnership (*Kommanditgesellschaft*, or KG), or civil law partnership (*Gesellschaft bürgerlichen Rechts*, or GbR) generate "rental income" as long as their activities are restricted to the mere holding and administration of real property (*Vermögensverwaltung*). Limited partnerships in which limited partners are not authorised to manage the partnership, and the general partners of which consist

exclusively of corporations, are deemed to generate “business income” even if they do not pursue business activities.

“Business income” is generally determined on an accrual’s basis. Income is, therefore, attributed to the year to which it economically belongs. Accounting records must be kept, and financial statements must be prepared. In general, all expenses connected with income derived from the real estate are deductible, such as maintenance and repairs, depreciation allowances and financing costs. However, “interest barrier rules” (*Zinsschranke*) may restrict the deductibility of interest expense for tax purposes.

For corporations, the starting point for determining taxable income is the income reported in the company’s annual accounts. Basically, all payments relating to the business can be deducted, unless they constitute acquisition or construction costs, in which case they are to be capitalised. Some adjustments are nevertheless made in order to bring the figures in line with the tax accounting rules.

The company’s income basis can so be reduced by deductible expenses connected with real estate, such as depreciation of buildings, repair, maintenance and similar costs. However, German tax regulations require that intercompany transactions comply with “arm’s length” principles in order to be accepted for tax purposes. Otherwise, adverse tax consequences can result. For instance, where the compensation paid by a German subsidiary to its foreign parent company is in excess of the amount that it would have paid to an independent third party. The excess amount is considered to be a hidden profit distribution, which is non-deductible in determining the subsidiary's taxable income. On top of the additional corporation and trade taxes payable by the subsidiary, dividend WHT at the standard rate of 25%, plus 5.5% solidarity surcharge, may be assessed on the shareholder. Accordingly, there are detailed transfer pricing documentation obligations that have to be observed to avoid the assumption of hidden profit distributions as well as the imposition of penalties for failure to comply.

Except for land, most tangible and intangible fixed assets are depreciable. The depreciation rules as described below do not, however, apply to property held as current assets. The standard depreciation method is the straight-line method. The basis for depreciation is the acquisition or construction cost. For buildings, the depreciation rates generally range from 2% to 3%, assuming a useful life of 33 to 50 years. Accelerated depreciation for buildings is permitted only in very limited scenarios. For moveable assets acquired in 2009 or 2010, the declining balance method at a rate of up to 25% may be used. For small and medium-sized companies, additional depreciation rates of up to 20% are available. In response to the COVID-19 pandemic, enhanced depreciation rates were introduced for movable assets acquired or made after 31 December 2019 and before 1 January 2022 increasing the existing depreciation rates by 2.5 with a maximum rate of 25% per annum.

The “interest barrier rule” may limit the tax deductibility of interest expenses even if the interest is agreed at “arm’s length” terms. The rules not only apply to interest paid on shareholder loans but to interest paid on all other loans, including bank loans, and not only to corporations but to any “business”, including business partnerships and sole proprietors.

The interest limitation is based on a disallowance of net interest expenses in excess of 30% of taxable income before net interest expenses, depreciation and amortisation (tax EBITDA). Interest disallowed for this reason can be carried forward and used in future financial years with no time limitation, but is, however, subject to the “interest barrier rules” in those years. This carryforward is to be mirrored with a carryforward of excess EBITDA, ie, EBITDA exceeding net interest expenses in the current year can be used to offset interest expense in subsequent years. The EBITDA carryforward period is limited to five years. A carryforward claim does not, however, arise in years in which a company was exempt from the interest limitation (see next paragraph).

The interest capping rules do not apply if one of the following three exceptions is met:

- Net interest expense is less than 3 million EUR annually;
- The German business is not part of a consolidated group of companies; and – in the case of a corporation or partnership with corporate partners – interest paid to a direct or indirect shareholder of more than 25% of the share capital (or a person related to such shareholder, or a person with potential recourse to such shareholder or the related person) does not exceed 10% of the net interest expense.
- Equity test: the German business is part of a consolidated group and the equity ratio (ie, equity in relation to the balance sheet total, certain adjustments apply) of the German business is not lower than the equity ratio of the consolidated group (except for a 2% deviation allowance); and – in the case of a corporation or partnership with corporate partners – interest paid by the business or another group company to a non-group shareholder holding directly or indirectly more than 25% of the share capital (or a person closely related to such a shareholder, or a person with potential recourse to such a shareholder or the related person) does not exceed 10% of the net interest expense. The relevant accounting standard for the equity test is generally IFRS. Alternatively, GAAP of any EU Member State or US-GAAP accounts may be used if no IFRS accounts are available.

Companies forming a fiscal unity (*Organschaft*) are, for German tax purposes, regarded as one business in the meaning of the interest capping rules.

Capital gains derived from the sale of real estate are, in general, taxable at the standard tax rates. An exemption applies only in the case of the sale of real estate by individuals more than ten years after its acquisition if not qualifying as “business income”. For income tax purposes, selling an interest in a real estate partnership is considered a sale of the real property. By creating a so-called “replacement or reinvestment reserve”, the taxation of capital gains realised on the sale of German land or buildings may be deferred and the tax burden effectively reduced. The capital gains may in certain cases be offset against the cost of assets which qualify as reinvestment objects (basically real property) acquired in the year of sale, or during the course of the following four years.

For income tax purposes, losses suffered by companies (also through participation in transparent partnerships) may either be carried back for one year (maximum limit of 1 million EUR), or carried forward with no time limit; however, the following restriction applies: while the first 1 million EUR of loss carryforwards may be offset in full against the taxable income of a subsequent year, taxable income in excess of this figure may only be offset by losses to the extent of 60%. As a result, a minimum of 40% of the income in excess of 1 million EUR is subject to tax. In response to the COVID-19 pandemic, the maximum loss carryback for losses accrued in 2020 and 2021 is 5 million EUR. Further differing from the regular procedure, a loss carryback from 2020 may be considered within the 2019 prepayments or tax assessment already before the 2020 assessment is made, based on a lump-sum loss carryback (30% of the tax base for the prepayments or assessment for 2019) or an estimate of the 2020 losses.

However, restrictions apply to the loss utilisation. Whenever more than 50% of the shares or voting rights in a corporation with tax loss carryforwards are transferred within a period of five years to one acquirer or a group of acquirers acting in concert, the accrued tax loss carryforwards as well as the current losses of the ongoing business year accrued up to the date of the harmful share transfer are forfeited.

Exceptions are available:

- in the case of the internal restructuring of a group, 100% held by a single shareholder;
- to the extent that the loss carryforwards do not exceed hidden reserves in the transferred company’s net assets.

Furthermore, for harmful share transfers occurring after 31 December 2015 it is possible to apply for relief from the forfeiture of tax losses, provided that the following requirements are met:

- The corporation has maintained exclusively the same business since the corporation was established or at least has maintained exclusively the same business in the last three periods of assessment before the period of assessment in which the harmful change of ownership arose.
- During this period the corporation cannot have been a controlling enterprise in a tax group (*Organträger*), nor can it have held an interest in a commercial partnership.
- Additionally, none of the harmful events which are listed in the provision (eg, the cessation of the business operation, the starting up of an additional business operation, a change of industry, etc) may have occurred in the above-mentioned three-year period.

The relief from tax loss forfeiture does not apply to losses which were incurred in a period prior to a previous discontinuance or dormancy of the business. This would apply, in particular, to situations where the corporation had discontinued its business in the past and then started a new business. The corporation must apply for application of the relief in its tax return for the period of assessment in which the harmful change of ownership occurred.

In the case where a loss-carrying corporation is merged into another corporation, all loss carryforwards are forfeited.

The rules apply also to interest carryforwards in the meaning of the “interest barrier rule” and to trade tax losses carried forward by partnerships to the extent the interests in the partnership are held by corporations.

In a decision of 29 August 2017, the Lower Tax Court of Hamburg referred the question to the German Federal Constitutional Court of whether the full forfeiture of losses in the case of a harmful share transfer of more than 50% is unconstitutional, which is the opinion of the Lower Tax Court of Hamburg. Only the Constitutional Court is authorised to decide if the regulation is unconstitutional.

Losses for trade tax purposes can also be carried forward, but not carried back. The relief for loss carryforwards generally follows the income tax rules.

The CIT rate is 15%. An additional 5.5% solidarity surcharge is levied (adding up to 15.825%) on the assessed income or the CIT payable. A German resident individual is subject to income tax according to a rate scale, which is proportional at lower and higher income levels, but progressive for middle income levels. The tax rate varies from 14% to 45%, in each case plus 5.5% solidarity surcharge thereon, and with a tax-free amount of 9,000 EUR.

The tax year in Germany is the calendar year. Tax returns are filed for each calendar year and reflect the financial statements for the business year ending in that calendar year. Returns are, in principle, due by 31st July of the following year. However, for tax returns prepared by a professional tax advisor, the deadline is extended to the last

day of February of the subsequent year. The tax will then be assessed by the authorities based on the information provided in the tax return and will be payable at the latest one month after the tax assessment is issued. The competent tax office can require tax prepayments to be made at quarterly intervals throughout the year with a final settlement when the assessment is issued.

The statute of limitations period is four years, and it commences at the end of the calendar year in which the tax return was filed with the tax authorities, or at the latest from the end of the third calendar year after the tax year. This period, however, is extended to five or ten years in the case of tax fraud. After the expiry of the limitation period, the tax assessed cannot be altered, rectified or rescinded.

Non-resident companies and individuals

Income derived by non-resident corporations from German real estate transactions is generally subject to taxation under the German Income Tax Act (ITA). Basically, the same income determination rules apply as for resident companies. The CIT rate applicable to non-resident corporate investors is the same as for resident ones: 15.825% (namely 15% plus 5.5% solidarity surcharge thereon).

Non-resident taxpayers are subject to certain restrictions with regard to the determination of the tax base: expenses are only tax-deductible if they are economically connected with taxable German income, specifically income that is not tax-exempt. Concerning the possibility to carry tax losses back or forward, the provisions mentioned above for resident companies are also applicable for non-resident companies if the losses arise in connection with what would have constituted German income. The losses can be offset against both operating income and capital gains realised on the sale of German property. Income subject to WHT, however, cannot be offset against losses from other categories of income, and losses arising under the heading “income from capital” can neither be carried forward nor back.

Individuals who are not resident in Germany are subject to tax only on their German-source income (“limited tax liability”). The determination of the tax base itself does not differ in principle from that in the case of non-resident companies described above. Non-resident individuals are taxed at the same tax rate as resident individuals without applying any a tax-free amount.

Withholding tax regime

The German tax regime comprises several obligations to withhold taxes at source as WHT.

A WHT regime applies eg, to German-source dividend income and interest income from profit participating loans. The WHT rate for such dividend and profit participating interest income is generally the 25% flat rate and definitive (plus 5.5% solidarity surcharge thereon adding up to 26.375%). There is generally no possibility of claiming expenses in the context of such income. The obligor of the dividend or profit participating interest payment is obliged to withhold and to remit the WHT on behalf of the recipient as the actual taxpayer.

If the recipient of payments subject to German WHT is a German tax resident, the WHT may be credited against the overall income tax liability. For specific dividends (eg, from stocks in collective deposit) received in 2016 or later the WHT may only be credited in full if further prerequisites are fulfilled, inter alia, a minimum holding period. In the case of non-residents, the WHT on dividend income is generally final unless the dividend is eg, part of the income of a permanent establishment (PE). Still, the WHT on dividends may be reduced under certain circumstances (EU Parent-Subsidiary Directive, DTT) if substance requirements are met.

Non-resident corporations receiving such dividends subject to withholding at source who cannot obtain relief according to a DTT or based on the EU Parent-Subsidiary Directive may generally nevertheless be granted a refund of WHT of 10%, resulting in a remaining final WHT of 15% plus 5.5% solidarity surcharge, which – in total – is equivalent to the German CIT rate for domestic corporations if substance requirements are met.

In accordance with the EU Parent-Subsidiary Directive, Germany fully exempts qualifying dividend payments by domestic companies to a company resident in another EU Member State from WHT. The following conditions must be met:

- Minimum direct holding of at least 10% of the issued share capital of the subsidiary by the EU corporation (at the time the dividend is paid).
- The shares are held continuously for a minimum period of 12 months.
- The corporation has sufficient substance in the meaning of the German ITA.

In the case of a DTT, WHT may be reduced, depending on the applicable lower rate. The German substance requirements must be met. As a general rule, the WHT rate for qualified shareholdings (of at least 10% in most cases) is 5%, whereas it is 15% for portfolio investments.

Moreover, in certain other cases, taxes have to be withheld in Germany:

- WHT on construction work (*Bauabzugssteuer*) is to be withheld at 15% of the consideration in certain cases by the recipient of the respective service on account of the company performing the construction, unless an exemption certificate has been granted by the competent tax authority or the invoiced amount of one company is less than 5,000 EUR (including VAT) in a current year. The service recipient is liable for failure to partly or completely pay the amount to be withheld.
- Wage tax has to be withheld by the employer for the remuneration paid to the employee (if any). The amounts deducted are paid to the tax office at regular, usually monthly, intervals. The actual deductions are calculated from the gross pay, taking the employee's marital, family, and other personal circumstances into account. For the employee, the wage tax deduction is a prepayment on the income tax due after filing one's annual income tax return. As such, the wage tax is a WHT and not a financial burden on the employer.

Trade tax (*Gewerbesteuer*)

Every company or taxpayer with business activities and a PE located in Germany is subject to trade tax (*Gewerbesteuer*), a tax payable to the municipalities.

"Rental income" is therefore not typically subject to trade tax, unless generated by a corporation or another entity deemed subject to trade tax.

The trade tax rate is a combination of a uniform tax rate of 3.5% (base rate) and a municipal tax rate (*Hebesatz*) depending on where the PEs of the business are located. Currently, municipalities with at least 80,000 inhabitants levy trade tax at a rate of between 12.6% (*Hebesatz* of 360%) and 20.3% (*Hebesatz* of 580%). Therefore, the overall effective tax rate ranges between 28.425% and 36.125%. Trade tax paid by a sole proprietor or an individual partner in a business partnership or a company limited by shares may reduce their individual income tax liability.

Trade taxable income is determined on the basis of the taxable income calculated for (corporate) income tax purposes, adjusted by certain add-backs and deductions.

The following add-backs will, inter alia, apply:

- 25% of total loan remuneration (short and long-term liabilities);
- 25% of total recurring payments (*Renten und dauernde Lasten*);
- 5% of total lease payments for moveable assets that qualify as long-term assets;
- 12.5% of total lease payments for immoveable assets that qualify as long-term assets.

These amounts would have to be added to the trade tax assessment basis of the debtor (eg, the lessee or borrower) insofar as the total amount exceeds 100,000 EUR. In response to the COVID-19 pandemic, the tax-exempt amount of trade tax add-backs was to be increased from 100,000 EUR to 200,000 EUR from the tax year 2020 onwards.

On the other hand, 1.2% of the unitary value (*Einheitswert*) of real property belonging to the business assets and not exempted from land tax can be deducted in the course of determination of the income for trade tax purposes (the "simple" trade tax deduction, in contrast to the extended trade tax deduction – see next section). The sale of a partnership interest generally constitutes a termination of business and as such is not subject to trade tax. However, capital gains realised by a corporate partner or by another partner who is not an individual at the time of sale of a partnership interest (or part of a partnership interest) are subject to trade tax at partnership level.

Extended trade tax deduction (*Erweiterte Gewerbesteuerkürzung*)

Even if a taxpayer's activities are, in principle, regarded as subject to trade tax, the effective tax burden may be avoided under the following conditions. A taxpayer that merely holds and administers their own real estate may apply for a so-called "extended trade tax deduction" (*Erweiterte Gewerbesteuerkürzung*). Such a deduction is made from the tax base for trade tax purposes of income derived from merely passive rental activities, thereby reducing the tax base for such activities to zero and effectively affording an exemption from trade tax.

A number of restrictions or prerequisites have to be considered in order to benefit from this exemption. For instance, so-called "business fixtures" (*Betriebsvorrichtungen*) may not be rented out along with the real property without jeopardising eligibility for the exemption. However, provided the dos and don'ts are observed, this exemption in practice provides a tax efficient strategy for high-yield investments and also avoids the imposition of trade tax on capital gains.

The extended trade tax deduction is explicitly excluded: (i) for any capital gains realised on the sale of a partnership interest in a property-owning entity, as well as (ii) for capital gains stemming from the disposal of a property was previously contributed to the company concerned on a tax-neutral basis within the three preceding years, (iii) for property that serves the business establishment of a partner, and (iv) for interest received by a partner on their loan granted to the partnership.

Real estate transfer tax (*Grunderwerbsteuer*)

Real estate transfer tax (RETT) is an important cost factor not only in direct acquisitions of property but also in share deals, or corporate reorganisations and restructurings. The object of taxation for RETT purposes is the real property located in Germany. Business fixtures are not viewed as real property. By contrast, hereditary building rights (*Erbbaurechte*) and buildings erected on land owned by a third party are also considered to be real property for RETT purposes.

RETT is levied on a number of transactions, such as purchase agreements, trade-off agreements, or purchase in a compulsory execution. In addition, an agreement to transfer one of these claims, as well as the transfer of the legal title of ownership without any underlying agreement, is subject to RETT.

Furthermore, where the aforementioned conditions are not met, but a party has de facto attained a position similar to that of the legally entitled owner, RETT may be imposed. This is the case when the recipient is able to benefit from all substantial proceeds from the use or disposal of the real property. The conditions differ slightly from the "economic ownership" concept for income tax purposes. Whether this also applies to cases of financial leasing under German tax law depends on the individual circumstances.

General RETT exemptions exist, eg, for transactions between related persons or transfers by way of inheritance. Other exemptions will rarely be of practical relevance.

Although, generally speaking, the transfer of shares in a corporation or of an interest in a partnership is not subject to RETT, there are some important exceptions. For example, all of the following are subject to RETT under current law:

- direct or indirect transfer of at least 95% of the interest in a German real property-owning partnership to new partners within five years;
- direct or indirect unification of at least 95% of the shares in a company or partnership owning German real property in the hands of one person, one company or in the hands of controlling and dependent businesses (RETT group/*Organschaft*); direct or indirect transfer of at least 95% or more of the unified shares in such a company or partnership; and
- transactions leading to a (partly) direct or (partly) indirect economic ownership of at least 95% in a corporation or partnership owning German real property (applicable for transfers realised after 6 June 2013).

It has to be noted that the Ministry of Finance and the federal states (*Bundesländer*) intend to amend the German RETT Act in order to broaden its scope to include share transfers of less than 95% as well.

On 31 July 2019, the Federal Government (*Bundesregierung*) resolved to broaden the scope of the RETT Act regarding share deals. A draft bill was introduced to the Federal Council (*Bundesrat*) on 9 August 2019. On 29 October 2019, the *Bundesrat* published a written statement on the comments on the draft bill adopted at its meeting on 20 September 2019. Further, the German parliament (*Bundestag*) circulated a draft bill on 29 September 2019. The fierce criticism from economic, science and parts of the tax authorities was also expressed unequivocally at the hearing of experts in the Finance Committee of the Bundestag on 14 October 2019. Subsequently, it was decided to revise the draft law and not to allow it to enter into force on 1 January 2020 as planned.

According to a draft bill the new rules cover:

- the lengthening of the monitoring period for transfers of interest in partnerships to ten years;
- the introduction of a new RETT triggering event for share transfers in corporations similar to the partnership regime;
- the lowering of the hurdle from 95% to 90%; and
- the lengthening of claw-back periods for certain privileges applicable to partnerships only.

However, the proposed reform to the German RETT law has been delayed. At present (November 2020), however, it remains open whether the initial draft bill will be implemented or substantially amended.

For future developments regarding changes in the German RETT law, please find PwC's *Real Estate Tax Services News* via www.pwc.de/real-estate-tax-services-newsalert-en.

Due to the complex rules, RETT may – eg, in a group structure – under certain circumstances be triggered twice, or even more often, in connection with the acquisition of one item of real estate. On the other hand, a tax credit is possible where one taxable transaction follows another that was already subject to RETT. It should be noted that, upon application, the RETT will not be imposed in certain cases, eg, if the transaction is reversed or the original transaction is rescinded within two years.

Certain cases of intra-group reorganisations are exempt from RETT. Such reorganisation must be either governed by the German Reconstructions Act, eg, in the form of a merger or spin-off, or similar statutory law of another EU/EEA country or implemented via contributions to a company by way of singular succession.

The exemption applies only to groups in which a group parent has directly or indirectly held 95% or more of the shares in the subsidiaries involved in the reorganisation for five or more years, and intends to keep these 95% or more shares for at least five more years after the reorganisation. Further, the transfer of property to or by a partnership – which from a tax viewpoint is transparent – is privileged by a partial RETT exemption if a partner participates in the transaction on both sides, either directly or through another partnership. The extent of the exemption depends on the proportion of interest in the partnership held by the participant. Although some legal restrictions apply in special cases and the anti-abuse case law has to be considered, the privileges for partnerships can often be used to minimise tax costs.

Proper RETT planning of group and partnership structures is required in conversion and reorganisation situations. The mere change of the legal form of a corporation into a partnership and vice versa does not, however, trigger RETT.

RETT is levied on the agreed consideration – in most cases the purchase price – at the applicable tax rate. The general tax rate is 3.5% (applicable for real estate in Bavaria and Saxony). Differing tax rates apply in most states. A tax rate of 4.5% applies for real estate located in Hamburg. A tax rate of 5% applies for real estate located in Baden-Württemberg, Bremen, Lower Saxony, Rhineland-Palatinate and Saxony-Anhalt. A tax rate of 6% applies for real estate located in Berlin, Hesse and Mecklenburg-Vorpommern. For real estate located in Brandenburg, North Rhine-Westphalia, Saarland, Thuringia and Schleswig-Holstein the applicable RETT rate is 6.5% (see illustration below). These tax rates are amended by the states on a frequent basis. For updates please click here.

A separate real property value (*Grundbesitzwert*) for RETT purposes applies to a number of special transactions. In detail, that special value basically applies to transactions where no consideration can be determined, such as group reorganisations, contributions in exchange for shares, unification of shares and other transactions based on statutory agreements. In this case, the value is determined by several factors (ie, developed/undeveloped area; type of building) and different evaluation methods such as the capitalised earning method (*Ertragswertverfahren*) or asset value method (*Sachwertverfahren*). The regulations of RETT apply, irrespective of whether or not the transaction itself is also subject to VAT. VAT is not part of the consideration for RETT purposes.

Value-added tax (*Umsatzsteuer*)

The basic concepts of the German VAT regime, such as taxable persons, the nature of the goods, delivery of goods and supply of services have been brought into line with the EU VAT System Directive. As a result, the German basic regulations are comparable to those applicable in the other EU Member States.

The German VAT system can be summarised as follows:

- A taxable person (entrepreneur) under the German VAT Act is a person who independently carries out an economic activity which, under the German VAT Act, is viewed as a supply of goods or services.
- Therefore, a company may be considered to be an entrepreneur for VAT purposes even though it only performs tax-exempt transactions (in such a case, however, the company will generally not be permitted to recover input VAT).
- The supply of goods means the transfer of the right to dispose of tangible property like an owner. Goods are notably tangible property, and some rights in rem giving their holder the right of a user over the immoveable property (eg, hereditary building right). Land and buildings are viewed as “goods” for German VAT purposes. However, a tax exemption exists for all transactions subject to RETT, in particular the sale of real estate.
- Supply of services means any transaction not constituting a supply of goods.

In principle, services supplied in connection with real properties fall within the scope of VAT. Most of these transactions are, however, exempt under German VAT law. This is, for instance, generally the case if real properties are merely rented, leased or sold and transferred. This includes lease financing activities in which the lessor is the economic owner.

Although transactions subject to RETT (hereditary building rights excluded), especially the sale of real estate, are VAT-exempt, they may voluntarily be subjected to VAT. Such a waiver of the VAT exemption can only be exercised

and declared in the notarised sale and purchase agreement. In this case, the real estate transaction now subject to VAT is taxed under the reverse charge procedure, ie, the buyer alone is liable for VAT. This treatment is applied if a sale is affected to another enterprise for purposes of the latter's business with the intention of VATable use by the purchaser (VAT option). No such VAT option is generally applied, if the purchaser intends to use the transferred asset for a non-VATable use, such as the letting of residential units. Additionally, the transfer of real estate can qualify as the so-called transfer of a going concern (*Geschäftsveräußerung im Ganzen*) especially if the real estate asset is sold and transferred together with existing lease agreements. In such a scenario, the transfer does not qualify as a transaction subject to VAT, but the purchaser takes the place of the vendor for input VAT adjustments in the event of a change in use.

Under certain circumstances, the VAT option applies to the letting of real estate, the transfer of hereditary building rights and other rights in rem. If the VAT option is exercised, the purchaser or lessor may in principle recover input VAT paid on their supplies and services and so reduce acquisition or construction costs considerably. When letting buildings partly for non-business purposes (ie, letting for housing or to public entities) and partly for business purposes, the VAT option is only applicable to the portion let for business purposes. In the case where the VAT option is exercised only for part of the letting turnovers, the input VAT may only be recovered in part as well. In this connection, the relevant ratio is to be determined with regard to the spaces let.

If the lessor waives the option to charge VAT on the "rental income" within ten years after acquisition or sells the property without charging VAT on the purchase price within that time frame, a portion of any input VAT initially recovered will have to be paid back.

Business-to-business (B2B) supplies of services are generally VATable where the recipient (not the supplier) of the services is located. The recipient has to account for the VAT under the reverse charge mechanism. The tax residency of the recipient can generally be proven by presenting a valid VAT identification number to the tax authorities. Services in connection to a property continue to be taxable at the place where the property is located.

The general VAT rate amounts to 19%. A reduced tax rate of 7% applies to certain goods and services such as letting accommodation for short periods, eg, by hotels. In response to the COVID-19 pandemic, the VAT rates have been temporarily reduced from 19% to 16% (general tax rate) and from 7% to 5% (reduced tax rate on certain goods and services) for the period between 1 July and 31 December 2020.

Land tax (*Grundsteuer*)

Land tax is a recurring annual tax levied by the municipal authorities and payable under the provisions of the Land Tax Act (*Grundsteuergesetz*).

All domestic real estate is subject to land tax unless a tax exemption applies. Basically, exemptions are granted if the real estate is used by certain public institutions or for public benefit.

The status of the owner of the property and the owner's individual income tax position are irrelevant for the computation of the land tax.

The tax base for the land tax is the unitary value. So far, the unitary value has been based on value ratios of the properties as of 1 January 1964 (in the territory of former West Germany) and 1 January 1935 (in the territory of former East Germany) according to the Valuation Tax Act (*Bewertungsgesetz*).

The land tax is assessed in a two-step procedure. In the first step, the tax authorities determine the base value (*Steuermessbetrag*) by multiplying the unitary value of the property with the applicable basic federal rate (*Steuermesszahl*). In the second step, the municipal authorities apply their local tax rate (*Hebesatz*) to the assessed base value.

The tax authorities attribute property to the taxpayer when assessing the unitary value.

The owner of the property is generally the taxpayer, but the holder of a hereditary building right or the beneficial owner may also become the taxpayer. In the case of the disposal of property, it is attributed to the new owner, holder of a hereditary building right or beneficial owner only from 1 January of the year following the transaction. Until this date, the property is attributed to the former owner, holder of a hereditary building right or beneficial owner.

With its decision of 10 April 2018, the German Federal Constitutional Court took the view that the existing rules of the Valuation Tax Act regarding the valuation of real estate for land tax purposes have been unconstitutional since the beginning of 2002.

The court noted that the values of real estate applied for the calculation of land tax should be kept as close to the market values as possible. However, this is not the case when considering the value ratios of 1964 which lead to unequal valuation results.

With the passing of the Law on the Reform of Land Tax and Valuation Law on 26 November 2019, the legislator reacted to the ruling of the German Federal Constitutional Court and has newly regulated the land tax in Germany. Nevertheless, current regulations will remain applicable up to 31 December 2024. The new regulations will come into force on 1 January 2025.

According to the new regulations, the determination of land tax values is generally carried out using the following methods:

- Land used for agriculture and forestry: special income method;
- Residential properties (eg, single-family houses, duplexes, rental properties and condominiums): simplified capitalised income method based on capitalised net income;
- Other properties (eg, commercial property, mixed-use land, part-ownership and other developed land): simplified asset value method based on normal construction costs.

The first valuation will be carried out on valuation date 1 January 2022. Further valuations are carried out every seven years or in the event of actual changes to the property.

Furthermore, the legislator has granted the federal states of Germany the right to establish their own valuation methods deviating from the valuation methods mentioned above.

So far, several states have already announced their own regulations (eg, Bavaria, Baden-Württemberg, Lower Saxony, Hamburg, Saxony). Other states will most likely follow. The models of the individual states are different in each case.

Due to the different valuation methods, the valuation of properties for land tax purposes will become much more complex from 2025 onwards, eg, for owners with real estate located in different states in Germany. In addition, the new regulations also require the property owner to notify the tax authorities of any changes to the properties.

The further steps of the land tax assessment remain unchanged.

It is as yet unclear whether the new regulations regarding the valuation of real estate for land tax purposes will lead to a tax increase. The aim of the German government is to secure the overall land tax revenue for the municipalities. Nevertheless, the new regulations will lead to an increase or decrease in the values of the individual types of properties in any case.

Land tax is a deductible expense for income tax purposes. The economic burden of land tax is usually transferred to the tenants by including it in the incidental rental charges. In the case of vacancies, however, the owner is stuck with the respective portion of the land tax.

Relief from land tax is granted under certain conditions and is generally applicable to public parks or to real estate constituting an important cultural asset. Relief may also be granted to land that is used for business purposes if what are deemed the gross earnings (*Rohertrag*) from the real estate are reduced by more than 50% due to exceptional circumstances.

German anti-hybrid considerations

In December 2019, the German Ministry of Finance released a draft bill regarding the transposition of the EU Anti-Tax Avoidance Directive (comprising (EU) 2016/1164, and the amending Directive (EU) 2017/952 – “ATAD II”) into German law. An amended draft bill was issued on 25 March 2020. The draft bill provides for changes in several areas; in particular it includes the implementation of anti-hybrid rules in German tax law.

The draft anti-hybrid rules seek to particularly prevent situations that give rise to a hybrid mismatch outcome, including a double deduction outcome and a deduction without inclusion outcome.

The German draft anti-hybrid rules have generally been designed to apply to arrangements between related parties or to arrangements affecting a company and its PE. However, anti-hybrid rules can also apply for certain “unrelated” party situations particularly in cases of structured arrangements.

Already existing anti-hybrid rules under current German tax law (eg, on double deduction in certain partnership and income tax group structures) are not abolished by the draft bill. Hence, those rules still need to be considered.

It has to be noted that at present, only the draft of the German Federal Ministry of Finance is available on which the Federal Government needs to decide prior to the introduction of the draft bill to the houses of parliament. Further changes may therefore be made in the course of the legislative process.

At present, it remains unclear as per what date the new regime will be applicable, as the draft bill had not been introduced to the houses of parliament in December 2019 as originally intended.

Nevertheless, given that Germany is obliged to apply the ATAD II rules by 1 January 2020 at the latest (or anti-reverse hybrid rules from 1 January 2022 onwards), at present, it cannot be excluded that the new regime will be applied retroactively as per 1 January 2020. According to the draft bill issued on 25 March 2020, the anti-hybrid rules would apply retroactively from 1 January 2020 onwards. However, in October 2020 the *Bundesrat* recommended postponing the effective date to 1 January 2021.

Mandatory reporting of cross-border tax arrangements

General remarks

With the "Act Introducing an Obligation to Report Cross-border Tax Arrangements" of 21 December 2019 ("DAC 6 Act"), Germany introduced a reporting obligation for certain cross-border tax arrangements. The regulations are to be applied from 1 July 2020. It should be noted, however, that also reportable cross-border arrangements whose first step was or will be implemented after 24 June 2018 and by 30 June 2020 must be reported between 1 July 2020 and 31 August 2020.

With the DAC 6 Act, Germany has implemented the Directive amending the EU Mutual Assistance Directive 2011/16/EU (6th Amendment Directive 2018/822/EU to the Mutual Assistance Directive – DAC 6) on the mandatory automatic exchange of information in the field of taxation on reportable cross-border arrangements, which came into force on 25 June 2018. The EU Member States were obliged to transpose the Directive into national law by 31 December 2019.

Due to the COVID-19 pandemic, EU finance ministers decided on 24 June 2020 that the EU Member States may postpone the expiry of the first reporting deadlines by six months. Germany did not make use of this possibility.

Reportable arrangements

A tax arrangement needs to be reported if it is cross-border related, meets at least one of the (so-called) hallmarks and refers to taxes covered by the German European Administrative Assistance Act. Taxes covered under the latter are all taxes that are levied by the EU Member States except VAT, customs duties and specific excise duties.

The hallmarks included in the German draft proposal are mainly in line with the hallmarks listed in Annex IV of DAC 6. It is not intended to include additional hallmarks.

In line with DAC 6, certain hallmarks will trigger a reportable tax arrangement only to the extent that the main benefit test (MBT) is met. The MBT is met if it can be established that the main benefit or one of the main benefits of a tax arrangement is obtaining a tax advantage.

Reportable persons

Based on the statute, the reporting obligation generally applies to the intermediary. An intermediary is any person who markets and – for third parties – designs, organises or makes available for implementation or manages the implementation of a reportable cross-border tax arrangement.

There must be a German nexus of the intermediary: this is assumed for intermediaries resident in Germany (eg, registered office, place of effective management, place of residence or habitual abode) or the intermediary is not resident in the EU and there is a certain domestic nexus if, for example, they provide their services related to the arrangement through a German PE. Intermediaries resident in other EU Member States are not subject to reporting obligations in Germany.

If the intermediary is subject to a legal professional privilege (eg, certified tax advisor, auditor or lawyer) and the intermediary is not released from this privilege, the obligation to report certain information passes to the user. Users themselves may be subject to the reporting obligation for all reportable information, if there is no intermediary that fulfils the conditions for a reporting obligation.

Procedures and deadlines for reporting

The reporting for cross-border arrangements must be made electronically to the German Federal Tax Office (*Bundeszentralamt für Steuern*) according to the officially prescribed data forms.

The reporting must be done within 30 days – in practice – even before the first step is taken for implementation, eg, when the arrangement is made available.

In addition, with regard to so-called “marketable cross-border tax arrangements” that do not have to be adapted individually, there is a notification period of ten days after the end of the calendar quarter, if changes or additions have been made to certain reportable information during a calendar quarter.

If a user has implemented a reportable cross-border tax arrangement, there is also a disclosure obligation in the tax return.

Sanctions for breaches of the reporting obligation

Violations of the reporting obligation are treated as administrative offences and are punishable by fines of up to 25,000 EUR.

Real Estate Investments

Investors wishing to invest in German real estate have various options in terms of the best way to structure the acquisition. Basically, the choice is between a direct acquisition of assets and an indirect acquisition, ie, through a purchase of shares in a company owning the targeted assets.

Rather than actually participating in the management of real properties, some investors may also wish to obtain a return on real estate through pure financial investments. For these investors, Germany provides a number of interesting instruments, such as open-end or closed-end real estate investment funds or the G-REIT.

As with any investment, the optimal real estate investment structure depends on the special objectives and needs of the investor. The use of investment strategies therefore usually depends on the status and goals of investors, the kind of investment and the legal status of investment at the time of investing, requirements of potential local or financing partners and other requirements. The following section provides an overview about the characteristics and consequences of these various alternatives or options for investments in German real estate, together with the tax and legal features regarding the construction of a new building.

Direct investments in German property

Acquisition of German real estate

Legal aspects

The right of ownership

Under the German civil law, the ownership right is defined as the right to possess, use and dispose of land in the most absolute fashion as long as no prohibited use is made thereof (absolute ownership). The right of ownership includes, besides the land itself, the following:

- the space above a piece of land and the subsoil to the extent that it is of interest to the owner.
- property attached to the soil (such as buildings), the products of the land and all items incorporated in a building during its construction.

Exceptions apply to business fixtures as defined for tax purposes (these being depreciated as movable property), even if they may be classified as an integral part of the real estate under civil law.

In addition, there are restricted ownership rights, such as condominium ownership and hereditary building rights, the acquisition of which is generally subject to the same statutory provisions as absolute ownership.

Sales agreement, transfer of title, notarial deed

The purchase of real property is effected through the conclusion of a sales agreement. The sales agreement should, inter alia, include an exact description of the property and the encumbrances relating thereto.

In addition, an agreement on the transfer of legal title must be concluded, and this has to be entered in the land register (*Grundbuch*). Legal ownership cannot be transferred to the buyer before the entry is made. Prior to the registration of transfer of title, the tax authorities must issue a clearance certificate (*Unbedenklichkeits-bescheinigung*) confirming payment of RETT.

Both agreements and all additional agreements legally relating thereto must be notarised, even if an assembly of business assets is acquired. The notary fees are based on the purchase price.

Tax aspects

Income tax

In addition to the introductory comments regarding the determination of the tax base (corporate and individual income tax), the computation of acquisition and construction costs is discussed in the following and the depreciation rates applicable to buildings are specified.

As the computation is in principle also applicable to individuals, no distinction is made between individuals and companies in the following.

For an asset with a limited useful life, the basis for depreciation is the historical cost, ie, the acquisition price (as referred to in the sales deed) plus incidental acquisition costs. The acquisition cost of the land and the additional costs relating thereto (in particular notarisation, land registry fees and real estate transfer tax) cannot be depreciated. Therefore, it is advisable to clearly specify in the purchase deed the portion of the acquisition price to be attributed to the land and to the building, respectively.

- Buildings belonging to a company's business assets, which are not let for housing purposes and were erected after 31 March 1985 (date of application for building permit), can generally be depreciated at an annual rate of 3% over a period of 33 years (straight-line method).
- If one of these conditions is not fulfilled, the annual depreciation rate for buildings erected after 31 December 1924 is 2% (depreciation period of 50 years).
- Buildings erected before that date are depreciated at an annual rate of 2.5% over a period of 40 years.
- Higher depreciation rates can be applied if the taxpayer can substantiate that the residual useful life of the building will be less than the above-mentioned periods.

Instead of applying the standard straight-line rates, buildings serving housing purposes and erected or purchased by end of 2005 may be depreciated on a declining balance basis at fixed rates (accelerated depreciation) if the investor erected them or acquired them in the year of their completion. In this case, the building permit must have been issued, or the building must have been acquired, after 31 December 1995. For buildings serving housing purposes, the declining balance depreciation was abolished from 2006.

Supplementary acquisition or construction costs incurred at a later date increase the depreciation basis for the building. In addition to depreciation, related costs, eg, maintenance, administration, land tax and financing costs, can be deducted immediately. Plant and machinery may be depreciated separately as moveable property, provided they are not an integral part of the real estate. Integral parts are those parts of the real estate that cannot be separated from the real estate without destroying or substantially altering either the real estate or its components.

Exceptions apply to business fixtures, which are depreciated as movable property regardless of whether they can be qualified as an integral part of the real estate under civil law.

Trade tax

Whereas the mere letting of real estate by individuals is generally not subject to Trade tax, certain activities such as such as commercial real estate dealings or trading in real estate (in contrast to passive property management), this can be seen as a first step to establishing a liability to trade tax. Further, trade tax can be triggered by the corporate form of the investor and a German PE of such corporate investors.

If the investor is a company and is engaged in passive property management but is subject to trade tax because its corporate form or maintains a PE, it needs to be analysed whether the specific activities qualifies for the extended trade tax deduction for passive real estate companies, thereby potentially reducing the tax base for trade tax purposes to zero.

RETT

In contractual practice, it is generally agreed that the costs and taxes incurred during the transaction process such as RETT as well as notary and land registration fees are borne by the purchaser, though generally both parties are liable for these costs vis-à-vis the tax authorities. The seller will, however, assume the costs of freeing the land from encumbrances. Based on case law, the tax basis for the land alone can be increased in certain constellations, so-called “unitary contractual framework” (*einheitliches Vertragswerk*). If, at the time the vendor concludes the sales agreement for the land, other agreements, eg, a construction contract, have been concluded, and these, together with the agreement for transfer of ownership of the land, can be considered a uniform set of agreements, the consideration that forms the tax basis for calculating the RETT payable, consists of the costs for the land and the building, even if the vendor of the property and the building constructor are not identical.

VAT

The sale of real property is in principle exempt from VAT. However, the seller may opt to VAT to the extent the real property is transferred to another entrepreneur for its business purposes. Such waiver of the VAT exemption can only be exercised and declared in the notarised sale and purchase agreement. Alternatively, a transfer of a real estate asset can qualify as a transfer of a going concern, especially, if the asset is let to third party tenants.

Acquisition of corporations holding German real estate

Real property owned by a corporate entity may be acquired by purchasing the shares in this company rather than purchasing the assets it holds. From a corporate tax viewpoint, this choice will usually have a significant impact for both the seller and the purchaser.

Legal aspects

The transfer of shares in a corporate entity with legal form of a limited liability company (GmbH) must be notarised.

Tax aspects

Income tax

A German property company may be acquired by a resident or non-resident company.

Resident corporations
Dividends from one German corporate entity to another are exempt from CIT, if the percentage of the shareholding at the beginning of the calendar year is at least 10%. However, an amount equivalent to 5% of the distributed dividends is treated as non-deductible business expense. As a result, 95% of the dividends received are tax-exempt. Expenses incurred in connection with such tax-free dividends are, however, fully deductible.

The participation exemption for dividends received by a portfolio investment is as of 28 February 2013 no longer applicable. A portfolio investment is an investment in which the shareholder holds less than 10% of the share capital of the distributing entity at the beginning of the calendar year. An acquisition of at least 10% of the shares within a calendar year is deemed to have occurred at the beginning of that calendar year. Capital gains realised upon disposal of portfolio investments generally will still qualify for the 95% participation exemption, if certain conditions are met. Generally capital losses will still not be deductible.

In addition, and especially with regard to hybrid instruments, payments, that were deducted from the tax base of the distributing entity for tax purposes, are not subject to the exemption irrespective of holding period and holding percentage.

The 95% tax exemption with respect to dividends from qualified shareholdings is under specific conditions not available to certain companies as recipients of a dividend, eg, banks, financial service institutions and certain finance businesses. In this case dividends are fully subject to CIT. According to Federal Fiscal Court case law applicable to the previous legal provisions (and still applicable to shares added to the business assets until 31 December 2016), holding companies could – under specific circumstances – also be viewed as a “finance business” for which the tax exemption is denied. For shares added to the business assets after 31 December 2016, following a change in the law, finance businesses are only excluded from the 95% exemption, if banks or financial service institutions hold a direct or indirect participation of more than 50% in the relevant finance business.

Simultaneously, capital gains derived by a German corporation on the sale of shares in both German and non-German companies are 95% tax-exempt (provided the shares are held long term).

WHT of 25% (plus 5.5% solidarity surcharge adding up to 26.375%) becomes due on dividends and capital gains but is refundable at the resident parent company level. A reduced rate of 15% is available for non-resident corporations under further substance requirements (see below).

The tax exemption for dividend distributions applies also to trade tax, provided the parent company holds at least 15% of the shares in the distributing company from the beginning of the fiscal year.

A fiscal unity can be established for CIT and trade tax law purposes by concluding a profit and loss (P&L) transfer agreement between a German corporation (subsidiary) and its parent if that parent is a resident business enterprise (sole proprietorship, partnership or company) and if that parent either directly or indirectly holds the majority of the voting stock of the subsidiary (financial integration).

The requirement of financial integration must be fulfilled throughout the entire accounting period of the subsidiary. In order for the fiscal unity to be recognised for tax purposes, the P&L transfer agreement must be recorded in the commercial register by the end of the first year for which it shall apply and must have been concluded for a term of at least five years. A termination of the agreement absent important cause within the five-year period will lead to retroactive non-recognition of the fiscal unity from the outset.

Non-resident corporations
A non-resident parent company and a resident subsidiary may enter into a fiscal unity for CIT and trade tax purposes from fiscal year 2012 on if the participation in the subsidiary can be attributed to a German PE of the non-resident parent company.

The tax treatment of non-resident companies that hold shares in a German resident company depends not only on German tax law but also on the applicability of the EU Parent-Subsidiary Directive and any DTT concluded with the acquirer's home country. The non-resident company with so-called “limited tax liability” is in principle subject to CIT with its German-sourced income similarly to the rules for resident companies, but WHT is generally not refundable for non-resident companies.

According to the EU Parent-Subsidiary Directive implemented in German tax law, no WHT applies if a German company distributes dividends to an EC corporate shareholder, provided that the latter has held directly 10% of the shares in the German company for an uninterrupted period of 12 months. Furthermore, the EC Parent-Subsidiary Directive is now also applicable in cases where an EC PE of a German or EC parent company receives dividends from a German subsidiary company.

The exemption from WHT (or its refund) only applies if a respective certificate has been issued by the Federal Central Tax Office. Otherwise, the regular WHT rate may be payable at the amount of 25% (plus 5.5% solidarity surcharge thereon adding up to 26.375%). This rate can, upon application, be reduced to the ordinary CIT rate of 15.825% (including solidarity surcharge) or lower DTT rate applicable.

Under various German DTTs, Germany reserved the right to tax gains arising from the sale of a corporate entity holding German real estate provided that the assets of the entity consist of more than 50% directly or indirectly held German real estate. If DTTs provide a right for taxation in Germany, the disposal gain of the non-resident shareholder on the sale of the shares in the German corporation is subject to German CIT. However, an amount equivalent to 5% of the disposal gain is treated as non-deductible business expense. As a result, 95% of the disposal gain is tax-exempt.

However, the German Supreme Court of Finance has ruled that disposal gains of non-resident and non-trading corporate shareholders on the sale of shares in German corporations are exempt from German CIT in full if certain conditions are met. According to the verdict full exemption from CIT on the sale of the shares provides that the shareholder neither has a PE nor a permanent representative in Germany or is trading with shares. In this regard, there might be a change of law in the future.

Substance requirements
Like in many other jurisdictions, substance is an important issue in connection with an investment in German real estate.

Strictly viewed, “substance” is an umbrella term frequently used to refer to a certain number of distinguishable elements, individually or collectively. Broadly speaking, however, what they have in common is that they denote requirements which an entity has to meet in order for that entity to be recognised as existing for tax purposes and to be accorded a certain desired tax treatment, most importantly deductibility of business expenses (notably shareholder loan interest payments) from the German taxable basis, and WHT relief under an EU Directive, or an applicable DTT.

The specific German anti-treaty/anti-directive shopping rule (section 50(d)(3) EStG) provides for relief from German WHTs (whether by refund or exemption), contingent on the entity or its ultimate beneficiaries, respectively, meeting rather strict substance requirements. German WHT relief can (only) be claimed to the extent that:

- the foreign company’s shareholders would have been entitled to a refund or exemption had they received the income directly; or
- the foreign company’s gross receipts in the respective business year stem from own active business activities; or
- for those receipts that do not stem from the foreign company’s own active business activities: (i) economic or other significant non-tax reasons exist for interposing the foreign company, and (ii) the foreign company has suitable business premises and equipment to participate in commerce.

The burden for proving that economic or significant other non-tax reasons exist, and that sufficient substance exists rests explicitly with the foreign company.

Since the European Court of Justice has judged these rules as too excessive, the government will revise these probably in the future. The German Ministry of Finance (*Bundesministerium der Finanzen*, or BMF)issued a circular according to which the substance requirements are substantially mitigated as follows:

- A company is considered as participating in the open market space even if its activity is limited to administration of own assets such as shares in subsidiary entities. However, this applies only if the company adequately exercises its rights as shareholder in its subsidiaries.
- It is no longer required that such company has permanent own staff on its payroll at all times. However, it is not stated whether part-time staff or no staff at all is required.
- It is permitted to refer to the corporate group in order to define the business reason for the implementation of the company.

The rules are not applicable to a foreign company if this company's main classes of shares are materially and regularly traded at a recognised stock exchange, or if the German investment tax laws are applicable to that company (eg, SICAV).

Individuals
Any capital gain realised by a resident or non-resident individual on the disposal of shares in a German corporation is subject to tax. If the seller has held 1% or more of the shares in the company at any time over the last five years, 60% of their capital gains are taxable at the ordinary progressive tax rate. If the seller has held less than 1%, 100% of their capital gains are taxable at a flat rate of 25% (plus solidarity surcharge adding up to 26.375%), if the shares were acquired after 31 December 2008 (see section above "*Real Estate Tax Summary/Withholding tax regime*").

For tax exemption according to DTTs see above (non-resident corporations).

However, if the participation forms part of the business assets of a German PE of the foreign vendor, Germany generally has the right of taxation.

RETT

The transfer of a shareholding in a corporation or an interest in a partnership as such is not generally subject to RETT. However, RETT will be levied where, as a result of the transfer:

- 95% or more of the shares in a real property-owning partnership are directly or indirectly transferred to new shareholders within a five-year period, or
- 95% or more of the shares in a real property-owning partnership or corporation are directly or indirectly assembled in the hands of one individual, partnership or corporation (or, under certain circumstances, in the hands of a group).

The threshold for avoiding the imposition of RETT is, as a result, less than 95%.

An indirect substantial change of the partners in a partnership is also subject to RETT. (This could arise, eg, where corporate entities are partners, and there are changes in the shareholders of these corporate entities.) By contrast, the transformation of a company into a partnership by a change in legal form will not trigger RETT. Certain cases of intra-group reorganisations are also exempt from RETT (see above "*Real Estate Tax Summary/Real estate transfer tax*").

The applicable tax rates range from 3.5% to 6.5% and are levied on a separate real property value (see above "*Real Estate Tax Summary/Real estate transfer tax*"). These tax rates are amended by the states on a frequent basis. For updates please click here.

At any rate, it is indispensable to consider RETT implications when contemplating reorganisations within structures involving property-owning entities.

VAT

The transfer of shares is usually VAT-exempt but may be subjected to VAT if the sale is effected to another entrepreneur for purposes of their business (VAT option), see section "*Direct investments in German property/Acquisition of German real estate/Tax aspects/VAT*" above).

Construction of German real estate

Legal aspects

Building permit (*Baugenehmigung*)

Before the erection of a building in Germany commences, a prerequisite is to obtain the necessary state permissions. This primary step is usually expensive and time-consuming. Obtaining the building permit for investments with a considerable yield perspective will vastly increase the value of a plot of land. The applicable rules relating to urban development and the environment differ between the various states. However, the rules relating to the planning permission can be briefly described as follows.

The erection of a building requires that a building permit is obtained beforehand from the municipal authorities. If such permission is refused, an objection may be lodged, which is usually decided upon by the higher building authority. Should it again be refused, then a claim may be lodged before the administrative court. Since such a procedure takes several years, an investor should instead try to negotiate with the competent authority in order to obtain the permit.

The competent authority must allow an application and issue a building permit if the planned project complies with public law provisions. To save time, it is common practice to make a preliminary application for a building permit (*Bauvoranfrage*) to clarify specific questions that may jeopardise its approval. In order to coordinate the complex legal, financial and planning questions prior to a development, it is recommended in practice to engage specialised development/property consultants if the investor does not have qualified staff for German investments at their disposal.

The contractor's status

Buildings of considerable size are usually erected by general contractors (*Generalunternehmer*), or general underwriters (*Generalübernehmer*). A general contractor will execute the construction work partly itself and will engage subcontractors for the remaining work, whereas a general underwriter will have the work done exclusively by subcontractors.

Both general contractors and underwriters are liable vis-à-vis the investor for the proper completion of the building in due course. Though the engagement of a general contractor or underwriter will usually involve higher building costs, the appointment is recommendable, as the investor is relieved of administration work, of negotiating with a large number of individual contractors, and of potential risks arising from each individual contract. For extensive building projects, it is also common practice that several contractors form a consortium (*Arbeitsgemeinschaft*, or ARGE), usually structured as a civil law partnership, with each member being jointly and severally liable for third-party claims. Such consortia are usually only concluded for the duration of a single project.

Tax aspects

Income tax

If an investor acquires a piece of land and a new building, they can be considered as having purchased the land and building, or as having acquired the land only and, as such, be the owner and responsible constructor of the building. The distinction is of importance for indirect tax and for income tax purposes in cases when tax allowances are not granted to the buyer of buildings.

In calculating depreciation during a rental period, the building is reflected in both cases at its construction or acquisition cost. This cost also includes fees incurred in connection with the application for the building permit and costs for the connection of the property to public utility services (for further details regarding income determination, see section "*Direct investments in German property/Direct purchase of assets/Tax aspects/Income tax*").

WHT on construction works

Targeting illegal employment practices in the construction industry, a WHT of 15% applies to the consideration for building services (*Bauleistungen*).

It can be credited against tax payable by the provider of the building services (the contractor) and may be refunded to the provider upon application.

The service recipient is liable for failure to partly or completely pay the amounts to be withheld.

No tax needs to be withheld in cases when the aggregate consideration in any one calendar year falls below the de minimis threshold (of 15,000 EUR or 5,000 EUR including VAT), respectively, depending on the individual case). Furthermore, the contractor can avoid the WHT deduction by obtaining, and presenting to the principal, an exemption certificate issued to them by the competent tax office.

VAT

VAT is a relevant cost factor in determining the cost price of a new building. Input VAT may only be recovered if the purchaser uses the building to achieve earnings from activities subject to VAT.

With regard to the above-mentioned tax exemptions, a VAT option may be exercised by the purchaser for resale or letting activities. The complex conditions for options require careful advanced planning to minimise financing costs.

However, also for newly erected buildings, input VAT recovery is subject to later correction if the circumstances under which the input VAT was initially recovered by the entrepreneur change within the ten subsequent years.

Selling German real estate

Legal aspects

Regarding the legal aspects of the sale of real properties see section "*Direct investments in German property/Acquisition of German real estate/Legal aspects*".

Tax aspects

Income taxes

Capital gains derived from the sale of real estate are generally taxable at standard rates if they are classified as "business income" of a German company or as "capital gain income".

Under certain conditions a rental activity may be classified as “trading in real estate” and therefore as a business activity. Under German case law, this is basically the case if more than three items of real estate (including the sale of items of real estate located outside Germany) are sold within five years (“three objects rule”). Furthermore, the risk of qualifying as traders in real property, even for investments including only one property, is considerably higher for individuals professionally involved in the real estate industry (such as architects, developers and agents) than for other individuals.

In addition, a capital gain derived by a non-resident on the sale of German real estate, which does fulfil the above-mentioned conditions is, in most cases, also subject to individual or CIT in Germany.

The taxable amount is the sales price minus adjusted book value of the property (acquisition costs at the time of purchase less depreciation allowances).

Rollover relief on capital gains

By creating a so-called “replacement or reinvestment reserve”, the taxation of capital gains realised on the sale of German land or buildings may be deferred and the tax burden effectively reduced. This requires, inter alia, that income is determined on an accrual’s basis. Furthermore, the building or land sold must have formed part of the business assets of a domestic PE for at least six years, and the newly acquired assets must also be business assets. For the sale of land and buildings, 100% of the capital gain may be deferred and deducted from the acquisition or construction cost of comparable assets, so resulting in a lower depreciation volume in the future. The property sold must be replaced within four years (six years if construction of a new building commences before the end of the fourth year) or released to income. The profit of the year in which the replacement reserve is released is furthermore increased by 6% of the released amount for each year the replacement reserve existed.

Trade tax

Capital gains will only result in a trade tax burden if a PE is maintained in Germany and the investment fails to qualify for trade tax exemptions which also apply to passive real estate investments.

The sale of an interest in a partnership is treated for tax purposes as a proportionate asset sale. Contrary to the situation on the sale of the property by the partnership, the gain realised on the disposal of a partner's interest is generally not subject to trade tax, as such a sale does not reflect a commercial activity by the partnership.

However, as outlined in the section “*Real Estate Tax Summary/Trade tax*”, the sale of a part of a partnership interest is subject to trade tax as well as the sale of a partnership interest by a corporation (or by another partner who is not an individual).

By contrast, the extended trade tax deduction is explicitly excluded, (i) for any capital gains realised on the sale of a partnership interest in a property-owning entity, as well as (ii) for capital gains stemming from disposal of a property which had been contributed on a tax neutral basis to the company in question within the three preceding years.

RETT and VAT

The same rules apply as outlined in the section “*Direct investments in German property/Acquisition of German real estate /Tax aspects*”.

Indirect investments via fund vehicles in German real estate

Closed-end real estate investment funds (*Geschlossene Immobilienfonds*)

These funds provide a common investment form for institutional and individual investors to participate in partnerships. Closed-end funds have become a very popular investment form, accumulating huge sums of money to finance projects, and banks and insurance companies currently offer, via their subsidiaries, the greatest investment opportunities.

With the implementation of the Alternative Investment Fund Managers Directive (AIFMD) the German Capital Investment Code (*Kapitalanlagegesetzbuch*, or KAGB) entered into force on 22 July 2013 and replaced the former German Investment Act (*Investmentgesetz*). The KAGB creates a unitary and cohesive system for all fund managers and all types of investment funds, especially, for closed-end real estate investment funds which were not regulated before the implementation of the AIFMD.

The KAGB applies on Alternative Investment Funds (AIF). AIF means any collective investment fund, which raises capital from a number of investors, with a view to investing it in accordance with a defined investment policy for the benefit of those investors and which does not constitute an undertaking operating outside the financial sector and which does not constitute an undertaking for collective investment in transferable securities (UCITS).

According to the KAGB, a closed-end fund is managed by a capital management company (KVG). The KVG is not subject to the Banking Act (*Kreditwesengesetz*, or KWG), but must obtain a business licence from the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungs-aufsicht*, or BaFin), prior to commencing operations.

The KVG needs to procure for a regulatory capital of at least 125,000 EUR (300,000 EUR in the case of an internally managed AIF), face registration and exhaustive reporting requirements and have to provide periodic reporting to national regulators, including details of illiquid assets, leverage and risk management methods.

There are two types of closed-end funds:

- Closed-end special AIF (*geschlossene Spezial-AIF*): only professional and semi-professional investors can obtain units in the fund.
- Closed-end German retail AIF (*geschlossene Publikums-AIF*): offered to the public, both individuals and corporations can obtain units in the fund.

Investors qualify as so-called "professional investors" in the case that they are regarded as professional clients or treated as professionals on request according to the Markets in Financial Instruments Directive (MiFID).

The German AIFMD-implementing Act introduced in Germany a new class of investors, ie, the semi-professional investor. A semi-professional investor is, inter alia,

(a) each investor

- who commits to investing a minimum of 200,000 EUR;
- who states in writing, in a separate document from the contract to be concluded for the commitment to invest, that they are aware of the risks associated with the envisaged commitment or investment;
- whose expertise, experience and knowledge have been assessed by the KVG or the appointed distribution company;
- with respect to whom the AIFM or the appointed distribution company is sufficiently convinced that the investor is able to make the investment decision on its own and understands the risks attached to it; and
- that the commitment is adequate for the investor and with respect to whom the AIFM or the appointed distribution company confirms in writing that it conducted the above assessment and that the above conditions have been met; as well as

(b) each investor who agrees to invest at the minimum 10 million EUR.

- The closed-end retail AIF may only invest in eligible assets. Eligible assets are for example tangible assets such as real property including woods, forest and agricultural land or units or shares in companies which may only invest in tangible assets.

With respect to the eligible investments of the AIF, the following applies:

- The principle of risk diversification needs generally to be observed (however, under certain conditions closed-end retail AIFs without risk diversification are possible).
- Loans may only be taken up to an amount of 150% of the capital of the AIF.
- The value of assets involving a currency risk may not exceed 30% of the capital of the AIF.

The closed-end special AIF does not have in effect any investment restrictions. The special AIF may only invest in assets, of which the market value can be determined.

Closde-ended German investment funds shall be launched only as investment stock corporations with fixed capital (*Investmentaktiengesellschaft mit fixem Kapital*) or closed-ended investment limited liability partnerships (*Investmentkommanditgesellschaft*).

The vehicle is, in most cases, a limited partnership. The position of the general partner is assumed by a limited liability company (GmbH), whereas the investors join directly or via nominee as limited partners. For German income tax purposes (but not for trade tax purposes) a limited partnership is transparent, ie, the income is taxed in the hand of the investors.

Though the income (as a net position of “rental income” and depreciation and other income-related expenses at the fund and investor level) is attributed to the individual investor, losses can only be considered under certain conditions. If the losses are to be considered at the level of the investor, they can be offset with other income sources.

Though closed-end real estate investment funds mainly attract German individual taxpayers with a high German income offset potential, they also attract increasing interest of some foreign investors.

Closed-end real estate funds represent a major share in the real estate market.

Open-end real estate investment funds (*Offene Immobilienfonds*)

These funds are also a significant factor in the German real estate market and the German investment fund industry, attracting an enormous amount of money. Both housing property and commercial property may be acquired. Investment in undeveloped land is possible under certain conditions.

There are three types of open-end funds:

- Open-end special AIF (*offener Spezial-AIF*): only professional and semi-professional can obtain units in the fund.
- Open-end special AIF with fixed investment rules (*Spezial-AIF mit festen Anlagebedingungen*): only professional and semi-professional investors can obtain units in the fund.
- Open-end German retail AIF (*offener Publikums-AIF*): offered to the public, both individuals and corporations can obtain units in the fund.

Open-end German retail AIF (a regulatory view)

The open-end fund is also managed by a KVG holding qualified assets (eg, real property) in its own name but on the account of the investors.

Investors hold investment units in the fund for which they have a redemption right (ie, the KVG redeems the units on the request of the unitholder).

The fund and the KVG are subject to legal regulations of the German KAGB. The taxation of the fund and the investors investing in the fund is governed by the Investment Tax Act (*Investmentsteuergesetz*, or InvStG).

Open-end funds may invest in certain assets ruled by the KAGB (eligible assets), but investment in real estate and real estate companies is generally permitted. Furthermore, the funds' assets have to be held in line with the principle of risk diversification (in the case of immovable property, this condition is met if more than three properties are held) and separately from the KVG's own assets.

With respect to the eligible investments of the fund, the following applies:

- The value of a single piece of real property may, at the time of acquisition, not exceed 15% of the asset value of an investment fund.
- The aggregate value of those properties exceeding an individual value of 10% of the fund's assets is restricted to a maximum of 50% of the value of the fund's overall assets.
- A minimum liquidity reserve of 5% of the fund's assets must be available at a daily basis for the redemption of the units.
- The value of assets involving a currency risk may not exceed 30% of total value of the fund's assets.
- Investments outside the EEA are only possible under certain conditions ie, if the investment rules provide so, an appropriate regional diversification of the assets and the free transferability of assets is ensured, and the movement of capital is not restricted in these states. Also, hereditary building rights may be acquired outside the EEA.
- It is in principle permitted to invest in multi-tier structures in the case, according to the fund regulations, such investments are allowed.
- The restriction of indirect investments to 49% of the fund's assets does not apply in the case of 100% shareholdings in real property companies.
- Up to 30% of the fund may be invested in minority shareholdings in real property companies.
- A real property company may acquire portfolios.
- Certain parts of the fund's liquid assets may be invested in stocks of German or foreign-listed REITs.

Open-end German special AIFs

Open-end German special AIFs are a sub-form of real estate investment funds and do not differ substantially from the open-end retail funds. In general, less investment restrictions are applicable on special AIFs from a regulatory perspective.

With respect to open-end special AIF with fixed investment rules, in principle, the rules for open-ended retail AIF apply. However, the KVG may deviate from several rules with the investors consent and if only real estate or interests in real estate companies are acquired. Loans may only be taken up for the collective account of the investors at the amount of up to 50% of the market value of the real estate comprised in the fund.

For the general special AIF, the resources may be invested in accordance with the principle of risk diversification and may only be invested in assets, of which the market value can be determined.

Special AIFs are subject to a reduced supervisory regime. The investor, therefore, benefits from lower management costs.

Taxation of AIFs since 1 January 2018 (general)

Although a contractual fund (*Sondervermögen*), as a pool of assets, is technically a general corporate income subject (*Zweckvermögen*), the German open-end funds are not subject to regular CIT rules but subject to the special tax rules of the InvStG.

The new fund taxation rules are applicable since 1 January 2018 onwards (there is no grandfathering regarding the application of the rules until 31 December 2017; ie, all funds need to follow the new rules).

The InvStG cover two independent taxation systems. Which taxation system is applicable, depends on whether the fund is categorised as an investment fund (*Investmentfonds*, so-called "Chapter-2-Funds") or a specialised investment fund (*Spezial-Investmentfonds*, so-called "Chapter-3-Funds"). It should be noted previous requirements to qualify as semi-transparent investment fund applicable under the tax rules until 31 December 2017 were – with minor amendments – transferred into new section 26 InvStG (ie, further apply to specialised investment funds). The treatment as specialised investment fund (ie, Chapter-3-Fund) for tax purposes is not directly linked to the regulatory treatment as special AIF under the KAGB (ie, a different qualification possible for tax and regulatory purposes).

General rules on harmful entrepreneurial management (*aktive unternehmerische Bewirtschaftung*) – which are seen as commercial activity subject to German trade tax – will further apply on investment funds (ie, would need to monitor properly to mitigate negative trade tax effects).

Whereas a semi-transparent taxation system will be applicable regarding specialised investment funds, the taxation of investment funds will differ fundamentally.

Taxation of investment funds (Chapter-2-Funds)

When categorised as an investment fund (see further comments in the following), the semi-transparent taxation system will not be applicable, ie, the fund as well as the investors will be taxed in a separate manner.

Every collective investment undertaking, especially open-end retail funds, irrespective of whether it is domiciled in Germany or not, will be governed by the principle of non-transparent taxation if not qualifying as a specialised investment fund (ie, Chapter-3-Fund).

Partnerships will only be included within the new regulations if the partnership's investment purpose solely serves pension-asset-pooling (ie, German closed-end AIFs are not subject to the InvStG).

The opaque taxation system is inspired by the predominant German taxation system of corporations. A lump-sum taxation system applies to investors (under certain conditions).

Without distinction, domestic and foreign investment funds will be subject to German CIT on the fund's German sourced income.

The investment fund can achieve exemption of German CIT if certain investors, eg, churches or pension schemes which are tax-exempt themselves, participate in the investment fund. Trade tax exemption can be achieved, if the income from entrepreneurial management would not exceed 5% of the fund's gross income (*unwesentliche aktive unternehmerische Bewirtschaftung*).

Collective investment undertaking vehicles will only be subject to German CIT at the rate of currently 15%, plus solidarity surcharge (if applicable), with their income derived from

- domestic dividends;
- domestic "rental income"; and
- other domestic income.

As a result, non-domestic income (like non-German dividends) are not taxed at investment fund level.

Distributions and gains considering the return, sale or withdrawal of a fund share are burdened with the German WHT or in the case of operating revenue with the tax rate applicable for the investor. Distributions are subject to the regular WHT regime. For non-German investors, generally no German WHT should apply.

The investors will be subject to tax – dependent on their individual tax status.

The investors may receive fund distributions, lump-sum advance amounts and gains from the de-investment in the fund (eg, via sale of fund shares or redemption). Lump sum advance is the exceeding amount of investment fund's income that was not distributed to the investors. Income with respect to the lump sum advance is defined as the multiplication of the fair market value of the shares with 70% of the basic interest rate as defined in section 203 subsection 2 of the German Valuation Code (on 4 January 2018 the Ministry of Finance announced a basic interest rate of 0.87%). Lump sum advances can be offset against a later capital gain from the disposal of shares in the investment fund. Assuming that real estate investment funds might regularly distribute its income, regularly no lump sum advance would apply at investor's level. However, this would need to be monitored considering the actual fund figures.

German individual investors holding the units as private assets are subject to so-called flat tax, ie, 25% (plus solidarity surcharge and church tax, if applicable); whilst individual investors that hold the units as business assets are subject to income tax with their individual tax rate. Corporate investors are subject to CIT and trade tax.

As far as no partial tax exemption is available the investment earnings from an investment fund would be fully taxable in the hands of German taxable corporate investor (German participation exemption does not apply on distributions received from an investment fund).

Partial exemption regulations apply for certain income on the level of the investors. If the investment fund invests continuously more than 50% of its value in equity participations, 30% tax exemption can be achieved if the fund share is part of the investor's non-business assets. A 60% tax exemption can be achieved if the fund share is part of the investor's business assets. Corporate investors are able to achieve an 80% tax exemption. If the investment fund invests continuously more than 50% of its value in real estates or real estate companies, the partial exemption amounts to 60% irrespective of the type of investor. If the investment fund invests continuously more than 50% of its value in non-German real estate or non-German real estate companies, the partial exemption will increase to 80%. It should be noted that there are still open questions on how above thresholds are calculated in practice.

Taxation of specialised investment funds (Chapter-3-Funds)

In order to qualify as a specialised investment fund (so-called "Chapter-3-Fund"), a collective investment undertaking has to fulfil, inter alia, the following requirements (amongst others):

- It must be a regulated entity, eg, by an AIFM.
- The investor has to have the right to redeem its share at least once in a year.
- Only certain investments are eligible.
- The number of investors is limited to 100, whereas every partner in a partnership which is invested in a fund will count as one investor.
- Investors are generally only professional or semi-professional investors (eg, no individual person).

As a general concept, the specialised investment fund is taxed as investment fund (as far as no special tax rules apply). Due to the special tax rules, the specialised investment funds can, inter alia, opt for the semi-transparent taxation system for German dividends, which are under the transparency option treated as directly received by the investors (ie, no taxation at fund level). German real estate income needs either to be taxed with German CIT at the level of the specialised investment fund; or a German WHT need to be levied on the German real estate income (for certain German investors, such WHT can be reduced to 0%; non-German investors will be subject to non-resident tax filing regarding the German "rental income"). The specialised investment fund will not be subject to CIT or German trade tax (no harmful entrepreneurial management required; a 5%-threshold regarding harmful income is to be considered).

The specialised investment fund needs to prepare a sort of partnership tax return which will allow to allocate income to the investors for tax purposes. Under this concept, certain income (like interest or "rental income") will be allocated to the investors irrespectively if distributed or not (ie, so-called deemed distributed income). Special rules apply to calculate the income for this tax return. As a result, the taxation will take place at the level of the investors (considering transparency options and German WHT rules).

Dependent on whether German WHT was levied at source (in the case of domestic income), WHT has to be levied on the fund level.

Current developments

The InvStG, as applicable since 1 January 2018, is a fully new law and the German Ministry of Finance (BMF) issued a circular to give guidance and explain certain interpretations for certain areas (eg, on Chapter-2-Funds). However, for other areas of the InvStG (in particular on Chapter-3-Funds) the BMF has only issued a draft circular. Hence, there are still certain topics, which are not clearly ruled by law or official guidance. As a result, certain areas are still subject to interpretation and market practice/standards need to be develop over the next years.

Real estate investment trusts

The German real estate investment trust (G-REIT) was introduced with effect as of 1 January 2007.

Legal aspects

The G-REIT needs to have the legal form of a stock corporation (AG). The required minimum capital is 15 million EUR. Both the statutory seat established in accordance with the corporate articles and the actual seat of management must be in Germany.

The G-REIT must be licensed to trade on an organised stock market in Germany, the EU or the EEA. The G-REIT Act does not provide for “private REITs” without stock market quotation.

At least 15% of the shares in the G-REIT must be widely spread, and from these shares no investor must hold 3% or more (“small investor rule”). At the moment of listing, it is even required that 25% of the shares must be held widely spread.

No individual shareholder must hold 10% or more of the G-REIT shares directly. Additional indirect holdings are possible to a certain extent.

The ownership and transfer of G-REIT shares are supervised by the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin). The G-REIT is subject to annual certification by its auditors as per 31 December, confirming that it has complied with the G-REIT specific rules. Failure to obtain such certification triggers penalties in different degrees of severity at the level of both the shareholders and the G-REIT, starting from penalty payments up to a potential loss of the G-REIT status.

Investment requirements

Seventy-five per cent of the G-REIT’s assets must consist of real property that is to be let, leased, or sold. Properties that are more than 50% let to residential tenants are non-eligible assets, unless they have been erected on or after 1 January 2007. Sale-and-lease-back arrangements are permissible without restrictions.

The G-REIT may invest in real estate holding partnerships and non-German real estate holding corporations provided that at least 90% of the corporation's assets consist of real estate that is located abroad.

Other activities such as management, brokerage, project control and developments for third parties may be undertaken through wholly owned subsidiary corporations (“G-REIT Service Companies”). The value of such G-REIT Service Company holdings must not exceed 20% of the G-REIT's total assets.

At least 75% of the REIT's proceeds must be derived from letting and leasing and the sale of real property. The total sales revenue generated by G-REIT Service Companies may not exceed 20% of the G-REIT's total sales revenue.

The G-REIT may not trade in real estate, ie, proceeds from the disposal of real estate held by the G-REIT and consolidated subsidiaries within the last five fiscal years must not exceed half of the value of the immoveable property held during that period on average.

The G-REIT's equity must not fall below 45% of the value of the real estate as stated in the financial statement at the end of the fiscal year. For example, if the real estate held by the G-REIT amounts to 75% of its total assets, the maximum debt financing would amount to 66.25%.

Tax aspects

The G-REIT is exempt from CIT and trade tax. This applies from the start of the financial year in which the registration as a G-REIT takes place.

In the case of a property sale, 50% of the capital gains realised may be transferred to a reinvestment reserve for a two-year period and rolled over to new eligible real estate.

Dividends of at least 90% of the distributable profits must be distributed every year. On these distributions, the general WHT of 25% (plus solidarity surcharge of 5.5% adding up to a total rate of 26.375%) applies.

Non-resident shareholders are subject to limited taxation in Germany on G-REIT dividends received. The WHT of 25% (plus solidarity surcharge adding up to 26.375%) is definitive for non-resident shareholders. The WHT exemption based on the EU Parent-Subsidiary Directive does not apply. However, a reduction of WHT to 15% may be available on the basis of the relevant DTT. A reduced rate of 15% (plus solidarity surcharge adding up to 15.825%) is available for non-resident corporations under further substance requirements (see explanation above). To avoid double taxation, G-REIT distributions stemming from pre-taxed income, ie, income that has been taxed in Germany or abroad at the rate of 15% or more, are 95% tax-exempt if received by a corporate taxpayer and 40% tax-exempt if received by a private individual holding the G-REIT share as a business asset (see section "*Acquisition of a German property company/Tax aspects*" above).

Individuals holding the G-REIT share as a private asset are subject to the 25% (plus solidarity surcharge adding up to 26.375%) definitive WHT regime, irrespective of whether the G-REIT distributions are stemming from pre-taxed income or not.

Further aspects with regard to the German Capital Investment Code

As REITs are not excluded from the scope of the AIFMD, each REIT should be analysed whether it meets the criteria of the definition of an AIF or not. Insofar, it is a case-by-case decision whether the requirements of the German KAGB apply.

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Real Estate Going Global

Greece

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

Currently real estate property in Greece is subject to various taxes. The possession, the use, the purchasing, the donation or inheritance of real estate property are currently subject to tax. Value-added tax (VAT) is imposed on new buildings as of 1 January 2006 in accordance with Law (L.) 3427/2005.

Individuals or companies (Greek and non-Greek) acquiring real estate property in Greece or receiving income from such property situated in Greece, need to obtain a Greek tax registration number (AFM) and file a Greek income tax return. Furthermore, foreign companies owning real estate property in Greece must also follow certain minimum accounting requirements, regardless of whether they maintain a permanent establishment (PE) in the country, in case they undertake building construction or extension works.

The tax laws L. 4172/2013 and L. 4223/2013 have amended Greek real estate taxation significantly. This publication seeks to convey the Greek real estate taxation situation after these several amendments, but it should also be noted that the Greek tax environment continues to be fluid.

Rental income

Rental income earned by individuals and companies is subject to Greek income tax.

For individuals, the income tax is based on the following tax scale (for income earned as of 1 January 2016):

Rental income (in euro)	Tax rate (in %)
0 to 12,000	15
12,001 to 35,000	35
35,001 or more	45

Said tax is imposed on the agreed rental after a deduction of, inter alia, 5% for expenses realised for maintenance/repair works. In this respect, said rental income should be included in the annual income tax return to be filed by the individual electronically up to 30 June of the year following the respective tax year.

The corporate income tax rate for legal persons and legal entities is 24% for any business income realised within tax year 2019 onwards except for the credit institutions taxed with the tax rate of 29%.

For individual beneficiaries, the overall net income of tax year 2018 onwards is subject to an extraordinary special solidarity contribution imposed at the following rates:

Total net income for the tax year 2018 onwards (in euro)	Special solidarity contribution rate (in %)
0 to 12,000	0
12,001 to 20,000	2.2
20,001 to 30,000	5
30,001 to 40,000	6.5
40,001 to 65,000	7.5
65,001 to 220,000	9
220,001 or more	10

Moreover, the own use of the free concession of the real estate property, in principle, gives rise to an annual deemed income derived from real estate, equal to 3% of the objective value of the property. An exemption from the aforementioned tax is provided in cases of the free concession of property up to 200 square metres to ascendants or descendants that is used by the latter as their main residence.

As of 2008, stamp duty of 3.6% on the rental of residential properties is abolished. Other rentals are still subject to 3.6% stamp duty.

Rentals are generally exempt from VAT. However, as of 1 January 2013 there is a possibility for any individual or companies subject to VAT to opt for charging VAT on rentals.

COVID-19 related note: Pursuant to the recently introduced provisions of Article 72(42) of L. 4172/2013, the unpaid amount of rent that has not been collected or is not collected as required by law in the context of dealing with the effects of the coronavirus, for all months in which the measure of reduced payment on the monthly rent corresponding to forty percent (40%) has been in force or will be in force does not constitute rental income and therefore is subject neither to income tax nor special solidarity contribution.

Thin capitalisation rules

According to the relevant thin capitalisation rules, excessive interest expenses (ie, interest expenses exceeding interest income or in other words net interest expenses) are deductible only up to 30% of earnings before income, taxes, depreciation and amortisation (EBITDA) calculated in accordance with tax accounting rules.

The interest expenses are recognised as fully deductible business expenses if the amount of the booked net interest expenses does not exceed the amount of 3 million EUR per year.

There are certain exceptions from the application of the thin capitalisation rules, applicable to banks, factoring companies, leasing companies, investment service companies, and securitisation special purpose vehicles (SPVs).

Depreciation

The buildings owned by the Greek companies are subject to mandatory annual depreciation, from the next month following the first own use of the property. The construction cost, including the cost of improvements, modifications is in principle subject to depreciation at the rate of 4%.

Real Estate Investments

Tax aspects

Value-added tax (VAT)

From 1 January 2006, the supply before first occupation of real estate is subject to VAT. The currently applicable rate is 24%. The taxable value is the price that the taxable person received or is deemed to receive or is anticipated to receive, increased by any additional provision connected with the abovementioned transaction.

In particular, a supply of real estate subject to VAT is considered to be the transfer for consideration of ownership or rights in rem of buildings or part of buildings and the land on which they stand, before their first occupation. The above transaction is taxable only when the following conditions are fulfilled:

- The person who transfers is a taxable person, or anyone who carries out, on an occasional basis, the aforementioned transaction on condition that he opts for the standard VAT regime; and
- The construction permit was issued after 1 January 2006.

The tax liability arises, and the VAT is due in a lump sum payment at the time of signature of the final contract.

Article 6 (4a) of L. 2859/2000 (VAT Code) provides for VAT suspension until 31 December 2022 and levying of real estate transfer tax on all unsold immovable property with a construction permit issued from 1 January 2006 onwards, upon relevant application by taxable persons. The application shall be submitted until 31 December 2020 for permits issued until 30 June 2020, while for permits issued from 1 July 2020 onwards there is a six-month deadline from the issuance of the permit. The acquisition of a first residence by individuals is exempt from the VAT.

Real estate transfer tax (RETT)

Any transfer of real estate which is not subject to VAT is subject to real estate transfer tax (RETT). The applicable RETT rate is 3% on the taxable value of the real estate property. The taxable base for the application of the RETT is either the objective value of real estate property or the agreed purchase price, whichever is higher.

The aforementioned tax shall be further increased by the 3% municipality duty applied on the amount of tax due.

Such RETT is reduced to a quarter in the following cases:

- distribution of real estate property parts among co-owners; or
- dissolution of partnerships and limited liability companies (Ltds).

RETT is reduced by half in the following cases:

- compulsory trade-off of neighbouring properties;
- merger of *sociétés anonymes* (SAs) or takeover of one by the other;
- takeover of real estate property by the state for public use and for the public benefit; or
- trade-off of real estate of equal value.

Certain other case-specific exceptions may also apply.

Special tax on real estate property

As of 1 January 2010, companies possessing ownership titles or rights of use of real estate in Greece pay an increased 15% annual tax calculated on their value.

The following are inter alia exempt:

(i) Legal entities irrespective of the country of their establishment, exercising commercial, manufacturing or industrial, activity in Greece, provided that the relevant tax year the gross revenue from this activity is higher than the gross revenue from the real estate they own.

(ii) Legal entities irrespective of the country of their establishment, constructing premises to use exclusively for the exercise of their commercial, manufacturing or industrial activity (self-use) and for a period of seven years starting from the issuance of the initial building permit.

(iii) Legal entities that have their registered seat in Greece or in an EU Member State, if they disclose their ultimate shareholders all the way up to an individual, who have a tax registration number in Greece. In case other legal entities are participating in the shareholder chain, the exemption is granted to the extent that the shares of the ultimate shareholder entity are traded on regulated exchanged markets.

(iv) Legal entities that have their registered seat in Greece or in an EU Member State or in a third country which is not considered as a non-cooperative country as per the Greek Income Tax Code (ITC), provided that they disclose their ultimate individuals shareholders, who have a tax registration number in Greece. In case other legal entities are participating in the shareholder chain, the exemption is granted to the extent that the shares of the ultimate shareholder entity are traded on regulated exchanged markets (which should be supervised by an authority accredited by the International Organization of Securities Commissions, or IOSCO).

It should be noted that the aforementioned disclosure of individual shareholders is not a prerequisite if the total of the shares is owned by a listed company or the whole or a part of the registered shares belong to:

- credit institutions including savings banks or deposit and loan funds;
- social security funds;
- insurance companies;
- mutual funds including:
  - closed-or open-ended real estate investment funds and their Managers;
  - real estate investment funds governed by L. 2778/1999, and their Managers;
  - venture capital funds (AKES) governed by L. 2992/2002.
- European long-term investment funds (ELTIFs) and their Managers regulated by EU Regulation 2015/760;
- Alternative investment funds (AIFs) and their Managers (AIFMs) regulated by L. 4209/2013 or/and EU Directive 2011/61;
- Undertakings for the collective investment in transferable securities (UCITS) and their Managers governed by L. 4099/2012 and Directive 2009/65/EC;
- European venture capital funds (EuVECA) and their Managers regulated by EU Regulation 345/2013;
- European social entrepreneurship funds (EuSEF) and their Managers regulated by EU Regulation 346/2013; and
- mutual fund managers and fund and/or mutual fund management and/or consulting companies, whose registered office is not in a non-cooperative country or in a country not assessed by the Global Forum on Transparency and Exchange of Information for Tax Purposes, as these are determined by Article 65 of the ITC and are supervised by a respective authority in their State of establishment.

By virtue of the provisions of Article 65(3) of L. 4172/2013 (ITC), as non-cooperative states are considered those that are not member states of the European Union, whose status, regarding the transparency and exchange of information in tax matters, has been examined by the Organisation for Economic Co-operation and Development (OECD) and has not been classified as "largely compliant" and which:

- have not concluded and applied with Greece a convention on administrative assistance in tax matters or have not signed the OECD Joint Convention on Mutual Administrative Assistance in Tax Matters; and
- have not committed themselves to automatic exchange of financial information beginning in 2018 the latest.

The person making the claim has to provide evidence in order to obtain the exemption.

Every individual or legal entity participating in any way in a legal entity having real estate ownership or participating in another legal entity that has ownership or other rights on real estate, is in whole responsible with the liable person for the tax payment.

If the ownership or usufruct is transferred, the liability for the payment of the tax, as well as for any additional payments, rests with the new owner or user together with the liable person.

The return is filed and the tax (if any) is paid by 20 May every year to the competent tax office, calculated on the objective value of all real estate or usufruct existing on 1 January of the taxable year.

Capital gains on the sale of property

Gains made by companies upon the sale of real estate property are treated as part of the company’s taxable profits and taxed at the currently applicable CIT rate of 24%.

For individuals, capital gain arising from the sale of real estate property located in Greece is subject to a 15% tax, unless such a sale is related to the exercise of a business activity.

A business transaction is considered as every single or coincidental action by which a transaction takes place or including the systematic performance of transactions on the economic market, with the purpose the creation of a profit.

Every three transactions of a similar nature taking place within a period of six months are considered as a systematic performance of transactions. In the case of real estate property, the respective time period is two years. The above criteria are substantiated by a solemn declaration of the seller, which shall be included in the respective transfer deed.

Such capital gain is calculated as the difference between the acquisition and sale price, taken into consideration an inflation adjustment. The acquisition price is considered as the value that is indicated on the initial transfer agreement.

The application of capital gains taxations upon the sale of real estate property by individuals is suspended until 31 December 2022.

Moreover, it is noted that upon the transfer of SA shares listed on the Athens or any other stock exchange a transfer tax (transaction duty) is imposed. The transfer tax rate (transaction duty) is calculated at 0.2% for sales of shares realised from 1 April 2011 onwards.

As of 1 January 2014, there is a 15% capital gains tax on the sale by individuals of various securities, including shares in real estate companies (and companies in general with some exemptions).

On the other hand, foreign companies shall not be subject to capital gains tax in Greece upon the disposal of Greek shares, provided that they do not maintain a PE in Greece.

Uniform tax on the ownership of real estate property (ENFIA)

As of 1 January 2014, onwards, a “uniform tax on the ownership of real estate property” (ENFIA) is applicable in Greece.

Said “uniform tax” takes the form of a principal tax per real estate property and a supplementary tax on the total value of the real estate.

More specifically, the ENFIA is imposed on property rights (eg, full/bare ownership, usufruct rights, etc) on real estate property located in Greece which are owned by individuals or legal entities or other entities as at 1 January of each year, irrespective of potential amendments taking place during the year and of the transfer of ownership title.

The principal tax on buildings is calculated by multiplying the square meters of the building by the principal tax ranging from 2 EUR to 13 EUR per square metre and other coefficients affecting the value of the property (eg, location, use, floor of the property, etc).

The principal tax on land is calculated by multiplying the square meters of the land by the principal tax ranging from 0.0037 EUR to 11.25 EUR per square metre and other coefficients affecting the value of the property (eg, location, use of the property, etc).

Individuals owning real estate property are also liable to a supplementary tax at a progressive tax rate ranging from 0.15% to 1.15% with a tax free threshold of 250,000 EUR of the total value of property rights subject to ENFIA, excluding the value of plots outside urban planning (agricultural plots) for the year 2019. The supplementary tax on legal entities or other entities is imposed at the tax rate of 5,5‰ on the total tax value of the subject property rights. This rate is reduced to 1‰ in relation to properties that are self-used by the entity for its commercial/business activity subject to ENFIA. ENFIA is imposed on the total value of property rights subject to ENFIA, excluding the value of plots outside urban planning (agricultural plots) and is determined for each taxpayer by a tax assessment act issued by the Tax Administration. Therefore, there is no obligation to file an ENFIA tax return.

Real estate investment trust (REIT)

General

The Greek REIT law was introduced in December 1999 by L. 2778/1999. The initial version of the law was poorly adapted to the needs of the market, and no REITs were established. The Greek REIT law was amended a few years later. A further second amendment to the law, which lifts a number of restrictions (eg, increases limitations on leverage, allows investments in real estate SPVs rather than only direct ownership of properties) may result in the establishment of more REITs. Further legislative amendments to the Greek REIT law (L. 4141/2013, L. 4209/2013,

L. 4223/2013, L. 4261/2014, and L. 4281/2014) followed in order to adapt to the current economic circumstances and facilitate the establishment of REIT structures in Greece.

The minimum tax for REICs originally introduced by virtue of L. 4389/2016 that significantly increased their tax leakage, has been abolished according to the relevant provisions of L. 4646/2019. Moreover, L. 4514/2018 (through which MiFID II Directive has been implemented in the Greek legislative framework) introduced certain minor changes relating to the field of the investments that a REIT may invest.

Considerable tax exemptions are the key advantage of the Greek REIT regime.

Greek REITs are special purpose entities. Their main activities consist of the investment in real estate assets prescribed by the Greek REIT law.

The Greek REIT law provides for two types of REITs:

1. Those having a unit trust form (real estate mutual funds, or REMFs). REMFs are not listed vehicles.
2. Those having a corporate legal form (real estate investment companies, or REICs). REICs must obtain a listing on a recognised stock exchange.

Real estate mutual funds (REMF)

A real estate mutual fund is managed by a fund management company, or *anonimi eteria diahirisis amiveon kefaleon* (AEDAK), formed as a SA, which must have a minimum paid-in share capital of at least 2,935,000 EUR (Article 2(5)(a), L. 2778/1999). Such a mutual fund is established following a licence granted by the Hellenic Capital Market Commission (HCMC). The assets under management must amount to at least 29,347,028.61 EUR (Article 5(2)(a)).

Certain requirements are set by law in relation to the operation of the AEDAK and the fund itself. It is required that the fund equity is invested in real estate property located in Greece or another EU Member State or in companies owning and exploiting real estate by holding at least 90% of their shares (Article 6(2)). Furthermore, the fund's equity should be invested in real estate assets as defined by the same law as well as in securities with a percentage not exceeding 10% of AEDAK's minimum share capital. However, the fund is not allowed to invest in precious metals or titles in such.

The fund property is divided in equal units or unit ratios, and each fund unit must be priced at least 14,673.51 EUR (Article 11(1)).

The establishment of the fund, the sale, redemption and transfer of units, its cessation of operations as well as the transfer of real estate to the fund, are free of any tax, duty, stamp duty, contribution or other Greek state charge. The transfer of assets to a REIT is not exempt from capital gains tax. Real estate mutual fund profits are subject to an annual tax of 10% on the intervention interest rate as determined by the European Central Bank (reference interest rate) increased by 1%. Tax is calculated on the six-month average of the fund's net assets. Neither the fund nor the investors are subject to any further tax for their relevant investment.

Real estate investment companies (REIC)

A REIC is set up as a SA, exclusively engaging in the management of portfolios comprising of securities and real estate, with a minimum share capital of 25 million EUR (Article 21(2) of L. 2778/1999). A REIC's reserves must be invested: a) at least 80% in real estate located in Greece or another EU or European Economic Area (EEA) Member State, b) money market instruments and securities and c) other moveable assets that serve the company's operational needs, provided that such assets do not exceed 10% in total of REICs assets (Article 22(1)).

The concept of real estate property inter alia includes:

- subsidiaries, holding or participation companies that are at least 80% owned, provided that such companies are exclusively engaged in real estate activities and invest in real estate property in which a REIC may also invest directly;
- companies being in a parent-subsidiary relationship with the REIC, at least 10% owned, provided that the subsidiary company is engaged in the acquisition, management and exploitation of property and its participation in the REIC is part of a common business strategy for the development of properties exceeding 10 million EUR in value; and
- a participation of at least 80% in UCITS investing in real estate investment companies, REITs and AIFs provided that said funds have received an operating licence in an EU Member State and are subject to the legislation and supervisory authority in such EU Member State and its assets are invested in real estate.

Real estate property is defined as property that may be used for commercial and generally business purposes (eg, hotels, tourist residences, marinas), or the exploitation of residential properties not exceeding 25% of the total real estate investments.

The L. 2778/1999 (Article 22) provides a number of restrictions on the nature of assets in which a REIT may invest, such as:

- Each individual property in which funds are invested may not exceed 25% of the total investment value of all properties.
- Property under development is allowed only to the extent that it is expected to be completed within 36 months from the issuance of the respective building permit or acquisition of property and that the budgeted remaining costs do not exceed 40% of the value of the property, which will be evaluated once works are completed.
- The REIT may not invest more than 25% of the total investments in properties acquired under financial leasing contracts. Furthermore, no more than 20% of the total investments in real estate property may consist of properties that the REIT does not fully own.
- Properties may not be disposed of less than twelve months from the date the properties are acquired, with the exception of residential properties and properties under construction.
- The acquisition or disposal of real estate property must be preceded by a valuation of the property by a Certified Evaluator, and the price paid may not deviate (upwards for acquisition or downwards for disposal) more than 5% from the value, as determined by the Certified Evaluator.

REICs are required to float their shares on the Athens Stock Exchange (ASE) or on another organised market within two years following their formation, provided that by the time of the listing at least 50% of the share capital of the company will be invested in real estate property. Such deadline may be extended, subject to the Capital Market's Committee approval, but the extension cannot exceed another 36 months in total.

REIC shares and the transfer of real estate property to such companies are exempt from any tax, duty, stamp duty, contribution or other similar Greek state charge. REIC profits are subject to an annual tax of 10% on the intervention interest rate as determined by the European Central Bank (reference interest rate), increased by 1% (Article 31). Tax is calculated on their six-month average investments increased by their cash reserves in current prices as depicted in the semestrial tables of investments, with no further tax obligation being imposed on the company or its shareholders. Furthermore, the transfer of REIC shares that are not listed on the Athens Stock Exchange is not subject to any income tax. The contribution of real estate assets to a REIC is not exempt from capital gains tax. RETT is not imposed in the case of REICs resulting from mergers or conversions. The transfer of real estate property to the REIC or REMF is exempt from RETT, and any other tax or duty in favour of the State or third parties. On the contrary, the transfer of real estate property by the REIC or REMF is subject to RETT.

REITs are subject to ENFIA and a supplementary tax at the standard rate (see above).

Finally, L. 2778/1999 does not contain any provision regarding REITs established outside Greece and, therefore, there is no framework for such companies to enjoy the tax benefits of the law in Greece.

Withholding tax on dividends

By virtue of the provisions of L. 4172/2013, a 5% withholding tax is imposed on profits distributed by Greek *Sociétés Anonymes* in the form of dividends, Board and Directors fees, profits distributed to personnel, as well as interim dividend payments made to individuals or legal entities, Greek or foreign.

Similar taxation is further imposed on profits distributed by Greek Limited Liability Companies (and some associations) to individuals or legal entities, Greek or foreign (application for distributed profits approved as of 1 January 2016 onwards).

Dividends distributed by REICs are not subject to the 5% withholding tax. For dividends received by REICs, the 5% withholding tax is deducted from the tax due following the submission of the tax return by the company. Any excess tax credit can be carried forward to offset the tax due with respect to future tax returns.

Loss carryforwards

Greek operating companies may carry forward their losses for a period of five years. Company losses cannot be carried back. Further, pursuant to L. 4549/2018 (amending the provisions of L. 4172/2013), if in a given tax year, a change in the direct or indirect ownership of the share capital or the voting rights of an entity in a percentage exceeding 33% takes place, and in parallel, a change of activity of the legal entity takes place in a percentage exceeding 50% of its turnover in relation to the immediately preceding tax year from the change of shareholding

structure or voting rights, the carry forward of losses will no longer be applicable for losses that the entity had during that tax year and for the previous five years.

Special merger incentives for real estate companies

By application of L. 2166/1993, Legislative Decree (L.D.) 1297/1972, and specific provisions of L. 4172/2013 (as in force), the merger between real estate companies is exempt from RETT.

Municipal tax system

Greek tax legislation provides for a great number of taxes and duties for the benefit of local authorities. Specifically, municipalities and communities benefit from two types of taxes:

1. Taxes imposed, managed and collected by the State, the revenue of which is partly or wholly distributed to the municipalities. These taxes finance the provision of public services.
2. Taxes and duties paid to the local authorities directly or indirectly (eg, through the electricity bills). These are generally established by law and imposed by virtue of a decision of the competent municipality council, which is occasionally granted a limited margin of discretion to determine the exact applicable tax rates, or even whether an optional charge will be levied.

Below is a brief description of the most important taxes and duties charged in favour of municipalities and communities in Greece.

Tax on the transfer of real estate

According to Article 37 of L.D. 3033/1954, in the case of a transfer of real estate, a tax in favour of the municipalities and communities is levied at a rate of 3% calculated on the amount of the real estate transfer tax due.

Real estate duty

According to Article 24 of L. 2130/1993, real estate duty is levied and collected through the electricity bill in favour of the municipalities and communities at a rate ranging between 0.025% and 0.035% on the real estate's objective value that is defined according to the "area prices" and "age coefficient" applicable on the respective property, depending on the area where the real estate property is situated.

Duty for the provision of cleaning and lighting services

A duty in compensation for the collection of garbage and waste and for the lighting of the streets, collected through the electricity bill, is due from the user of real estate. According to Article 1 of L. 25/1975, these duties are calculated by multiplying the real estate's square metres by a certain rate determined by the municipal council.

Tax on electrified spaces

According to Article 10 of L. 1080/1980, the municipal council may levy a tax on real estate connected to the grid, the collection of which is effected through the electricity bill. The tax is calculated by multiplying the real estate's square metres by a rate determined by the municipal or community council ranging between 0.018 EUR and 0.073 EUR per square metre. The said rate can be increased every year up to 20%.

Advertisement duties

According to the applicable Greek tax legislation, advertisements are divided into four categories: A, B, C and D for taxation purposes.

- Category A: Advertisements in public areas, eg, squares, pavements, buildings under construction, train stations, airports, stadiums, shops, cinemas, theatres, kiosks. A fixed duty amount determined by the municipal or community council is imposed weekly, multiplied by the square metres of the surface covered by the advertisement.
- Category B: Well-lit advertisements are charged with a municipal duty per square metre on an annual basis. The duty amount depends on the specifications of the advertisement and is determined by the municipal or community council.

- Category C: Advertisements on public means of transport. The duty depends on the size of the advertisement.
- Category D: Advertisements through gifts, diaries, handbills of any kind, stickers, or brochures in restaurants, cafes, etc, or by the use of an airplane, are taxed at a rate of 6% on the advertisement expenditure. Such rate is further reduced to 2% in case advertisements are effected through open display within stores.

TV, radio, magazines and newspaper advertisements are not subject to this duty.

Duties for the use of communal space

A duty in compensation for the granting of the right to use pavements, squares and other public spaces is due by the user. The duty amount is determined annually per square metre used, by the municipal or community council.

Duties for the use of public land, projects or services

Generally, the municipality or community can impose duties in compensation for the use of its land, projects or services (eg, water supply, quarries, extraction of sand and stones from a municipal or community quarry, etc). The specific conditions concerning the imposition of the aforementioned duties (eg, rate, basis of assessment, etc) are determined by the municipal or community council.

Duties on hotel bills

A municipal and community duty of 0.5% is imposed on the amount paid for bed, rendered room or apartment or camping spaces in an organised hotel, including rooms to let, or a camping site. The duty is payable by the customer and is collected by the lessor, who is responsible for the payment of the duty to the competent local authority.

Further, as of 1 January 2018, an “accommodation duty” is introduced by virtue of Article 53, L. 4389/2016 which provides for duty levied on the customer and calculated on a daily basis on the hotel rooms occupied by a customer as per the following:

- for 1-2 star hotels: 0.50 EUR per day;
- for 3 star hotels: 1.50 EUR per day;
- for 4 star hotels: 3 EUR per day;
- for 5 star hotels: 4 EUR per day; and
- for rented furnished rooms/ apartments: 0.50 EUR per day.

Duties on restaurant bills

Based on L. 4483/2017, municipal and community duty of 0.5% is imposed on the gross revenue of: (i) all establishments serving food, drinks, coffee, refreshment, sweets and dairy products, on condition that they, according to their operating licence, dispose of seats and tables inside or outside the facilities; (ii) bars and beer shops, irrespective of their name and category; and (iii) canteens.

In the case of entertainment clubs (nightclubs, discos, music halls, cabarets, establishments offering drinks and shows), the abovementioned municipal charge is 5%.

A similar duty may also be imposed on the gross revenue on several categories of trade shops such as those that sell tourist, sport, skiing and folk art items, souvenirs and gifts, rent-a-car establishments, schools offering classes in sea sports, etc, based on the decisions of the competent local authority.

The aforementioned duty is payable by the customer and is collected by the issuer of the bill, who is responsible for the payment of the duty to the competent local authority.

Tax on building licences

In favour of municipalities and communities, a tax is imposed on the issuance of any licence concerning the construction, completion, addition, extension or arrangement of buildings within the administrative limits of a municipality. The tax is calculated at a rate of 0.5% on the estimated budget of the said operations as determined by the competent authorities.

Parking duties

The duties for parking in public areas, established by L. 2218/1994, are determined by decision of the municipal or community council.

Duty on commerce of drinkable waters

A duty is levied on the commerce of drinkable waters, sold in their natural condition or after processing or mixing with other juices, under any name or package, from a trader having obtained the necessary licence.

The duty is computed at a rate ranging between 0.03% and 0.05% levied on the total value of the relevant sales as determined by the accounting books and records of the selling entity. The specifications of this duty are determined by the competent municipal council.

Local projects and services duties

In general, municipality councils are granted a margin of discretion to determine specific duties, in compensation for local projects and services, which contribute to the development of the area, the raising of quality of life and the better service of the citizens. The specifications and details of the aforementioned duties are determined by the competent local authorities and have to correspond to the actual cost of services or projects.

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2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

Foreign investors may invest in Hong Kong property through a non-resident entity or, more commonly, through a resident entity.

Rental income

Rental income derived from Hong Kong property is taxable in Hong Kong SAR. If the property owner is a company, whether resident or non-resident, the rental income is liable to profits tax at the rate of 16.5%.

Hong Kong SAR introduced a two-tiered profits tax rates regime for corporations and unincorporated businesses in 2018. Under the two-tiered profits tax rates regime, the profits tax rate for the first 2 million Hong Kong dollars (HKD) of assessable profits will be lowered to 8.25% (ie, half of the prevailing standard tax rate of 16.5%) for corporations and 7.5% (ie, half of the prevailing standard tax rate of 15%) for unincorporated businesses such as partnerships and sole proprietorships. Assessable profits above 2 million HKD will continue to be subject to the standard tax rate of 16.5% for corporations and 15% for unincorporated businesses. For a group of "connected entities", only one entity within the group can elect to apply the two-tiered rates.

If the property owner is an individual, whether resident or non-resident, then the rental income is subject to property tax at the rate of 15%.

Corporate investors

Interest on loans used to acquire property can be deducted against rental income if (a) the lender is subject to tax on the interest income in Hong Kong SAR, or (b) if the lender is a financial institution and (i) the loan is not secured or guaranteed by any deposit or loan from which the interest derived is not subject to tax in Hong Kong SAR, and (ii) there is no arrangement in place whereby the interest on the money borrowed would flow to the borrower or to certain person connected with the borrower, subject to some exceptions.

Other costs incurred in deriving rental income, such as insurance premiums, repair and maintenance expenses, property management fees, etc, are also deductible. Capital expenditures, such as stamp duty and legal costs incurred in acquiring the property, are not deductible.

Individual investor

Property tax is levied on the rental income received after deduction of government rates, if these are paid by the property owner. A notional deduction of 20% of the net rental income amount is also allowed to cover repairs and other recurrent expenses.

Resident individuals may opt for personal assessment, whereby the net taxable rental income is offset by the attributable mortgage interest incurred, if any. The net amount is then subject to tax, either at progressive rates with the deduction of personal allowances, or at the standard rate of 15% without the deduction of personal allowances, whichever is lower.

Stamp duty

A lease agreement is subject to stamp duty, generally at a rate of 0.25% to 1% of the average yearly rent, depending on the length of tenancy.

The government has implemented various measures to curb short-term speculation which included changes in the ad valorem stamp duty rate, and the introduction of special stamp duty and buyer's stamp duty on transfer of properties.

Ad valorem stamp duty

Unless specifically exempted or otherwise provided for, the transfer of Hong Kong residential property where the agreement is executed on or after 5 November 2016 would be subject to Hong Kong ad valorem stamp duty (AVD) at the rate of 15% on the higher of the sales consideration or market value of the Hong Kong residential property.

Also, unless specifically exempted or otherwise provided in the law, acquisition of more than one residential property under a single instrument executed on or after 12 April 2017 would be subject to AVD at the rate of 15% on the higher of the sales consideration or market value of the Hong Kong residential properties, even if the purchaser/transferee is a Hong Kong permanent resident who is acting on his/her own behalf and does not own any other residential property in Hong Kong SAR at the time of acquisition.

In respect of non-residential property, unless specifically exempted, the transfer would be subject to AVD of up to 8.5% on the higher of the sales consideration or market value of the Hong Kong non-residential property.

All parties to a contract are liable to AVD although it is normally payable by the purchaser.

Special stamp duty

Hong Kong SAR introduced a special stamp duty (SSD) with effect from 20 November 2010. Unless specifically exempted, any residential property acquired on or after 20 November 2010, either by an individual or a company (regardless of where it is incorporated), and resold or transferred within a specified period of time after acquisition, would be subject to SSD. The SSD payable is calculated by reference to the stated consideration or the market value, whichever is higher, at the following regressive rates for the different holding periods by the vendor or transferor before the disposal. The SSD rates were revised for any residential property acquired on or after 27 October 2012.

Period within which the residential property is resold or transferred after its acquisition	**SSD rates for residential property acquired on or after 27 October 2012 (in %)**
6 months or less	20
More than 6 months but for 12 months or less	15
More than 12 months but for 36 months or less	10

All parties to a contract are liable to the SSD. However, in practice, commercial considerations will influence the allocation of stamp duty liability between the parties.

Buyer’s stamp duty

Hong Kong SAR introduced a buyer’s stamp duty (BSD) with effect from 27 October 2012. Unless specifically exempted, a purchaser (any individual without Hong Kong permanent residence or any corporation irrespective of its place of incorporation) would be liable to BSD for transfer of residential property on or after 27 October 2012. BSD is charged at 15% on the higher of sales consideration or market value. The purchaser is liable to pay BSD.

Depreciation allowances

Corporate investors are entitled to a tax depreciation allowance on the property in computing their liability to profits tax. Accounting depreciation is capital in nature and is not tax-deductible.

Certain components of a building, whether new or second-hand, may be considered to be plant or machinery. These are tax depreciable by way of an initial allowance of 60% of the cost in the year of acquisition, and an annual depreciation allowance ranging from 10% to 30% of the depreciated value, depending on the nature of the plant and machinery. Lift equipment or elevators, escalators, air-conditioning systems, sprinklers, etc for example, are considered to be plant or machinery eligible for a 60% initial depreciation allowance and an annual depreciation allowance at the rate of 10%. For certain environmental protection facilities, 100% tax deduction is available for the year in which the capital expenditure is incurred.

A building or structure, or a part thereof, other than the physical plant and equipment, may be eligible for a tax depreciation allowance on the cost of construction. If the building or structure is used by the owner, or its tenant, in a qualifying business, such as milling, manufacturing, transportation, public utilities, farming and trade of storage, etc, then an industrial building allowance is available. An initial depreciation allowance of 20% on the cost of construction is available for the first use of an industrial building, and an annual depreciation allowance at the rate of 4% on a straight-line basis is available where the building or structure remains in use in a qualifying business.

For a second-hand industrial building, the annual allowance is computed by reference to the unclaimed residual tax value and balancing adjustment (see below), divided by the remaining portion of the building's statutory deemed useful life of 26 years.

In respect of new buildings or structures other than those qualifying as industrial buildings, an annual commercial building allowance of 4% of the construction cost is available. For a second-hand commercial building, the annual allowance is computed on the same basis as an industrial building.

When the relevant interest in the building or structure is sold, or the building or structure is demolished or destroyed, there may be a balancing adjustment on the unclaimed tax residual value by reference to the sale proceeds, resulting in either a deductible balancing allowance or a taxable balancing charge.

For capital expenditure relating to the renovation or refurbishment of a building or structure (other than a domestic building or structure), corporate investors may alternatively claim an annual profits tax deduction at the rate of 20% on a straight-line basis.

No tax depreciation allowance on the building or property is available to an individual investor who is subject to property tax.

Capital gains on the sale of real property

There is no capital gains tax in Hong Kong SAR. A gain on disposal of real property may, however, be liable to profits tax if the owner is engaged in a venture in the nature of a trade in real property.

Withholding tax on dividends

There is no dividend withholding tax in Hong Kong SAR. A resident company may distribute its retained earnings to shareholders, whether resident or non-resident, tax-free.

Loss carryforward

Tax losses may be carried forward indefinitely to offset future taxable profits. There is no loss carryback.

Rates and Government rent

Rates are charged at the current rate of 5% on the rateable value, which is the estimated annual rental value of property. Rates are payable by either the owner or the occupier, depending on their agreement. In the absence of any agreement to the contrary, the liability to rates rests with the occupier.

Government rent applies to land held under a Government lease that expired prior to 30 June 1997 or has been granted since 27 May 1985. Government rent is calculated at 3% of the rateable value of the property. The owner is liable for Government rent, unless there is an express agreement to the contrary.

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Real Estate Going Global

Hungary

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Investments

Legal considerations

Basic principles

Certain rights (including ownership) and physical and legal data relating to real properties and specified by the law must be registered in the Land Register, which is maintained by the Land Registry Offices. Individual properties are identified by topographical lot numbers.

The information recorded on the title deed of real properties is open for inspection by the public. Although the documents underlying the data registered in the title deeds are confidential, they could be obtained with a power of attorney from a party who proves legal interest to the documents in question.

Some specified rights over a real property (for example ownership) are constituted by their registration in the Land Register. These rights can only be exercised once they have been officially registered. Accordingly, the transaction-based transfer of ownership must be registered with the Land Registry in order to have the ownership transferred. Furthermore, the establishment or modification of certain other rights (eg, mortgage and usufruct right) over real properties must be registered with the Land Registry in order to have the respective right established or modified.

As a general rule, an entry relating to a right over the real property must be based on a notarial deed, private documents with full probative force or a written document countersigned by an attorney-at-law. However, in some cases (eg, in the case of the registration of ownership or option right), only a notarial deed or a written document countersigned by an attorney-at-law is acceptable. In these cases, legal representation is also compulsory in Land Registry procedures. The Land Registry Offices must decide on applications for registration in the order, in which they were filed.

Bona fide third parties acquire ownership in spite of the actual legal situation, if they acquired the property for consideration and with the assumption that the entries in the Land Register are correct (ie, they purchased the property from a registered owner).

Ownership by a local company

The Hungarian Corporate Law recognises four principal corporate forms. A limited liability company (Kft.), which requires a minimum of 3 million Hungarian forints (HUF) - approximately 8,500 EUR - as registered capital, is one of the most popular forms for foreign investors. A Kft. is owned by quota-holders whose names are registered with the Court of Registration. The ownership of a company limited by shares (Rt.) is represented by transferable shares. For a private company limited by shares (Zrt.) a minimum of 5 million HUF (approx. 14,300 EUR) as registered capital is required. The required minimum registered capital for a public company limited by shares (Nyrt.) is 20 million HUF (approx. 67,100 EUR). Other available corporate forms are limited and general partnerships (Bt. and Kkt.). They have legal personality too. However, these forms are more popular amongst micro enterprises and domestic entrepreneurs. All owners of a Kkt. and certain owners of a Bt. have unlimited liability towards the creditors of such an entity. All of the above-mentioned corporate forms may acquire the ownership of any Hungarian real property without any special licence whatsoever, except for agricultural lands, which cannot be acquired by companies in general at all.

Ownership by a foreign company

In principle, foreigners (ie, non-Hungarian citizens) may own Hungarian real properties, except for agricultural lands. Usually, a licence from the relevant administrative office (“Government Office”) is required for an acquisition by a foreigner. However, EU citizens, corporate entities and other organisations (regardless of legal personality) registered in an EU or EEA Member State (or a third state deemed to enjoy the same status pursuant to an international treaty) do not require any licence for acquiring the ownership title over a real property and they can even acquire agricultural lands.

Tax considerations

Corporate income tax (CIT)

Corporate income tax rate

From 1 January 2017, the corporate income tax rate is flat 9% of the positive corporate income tax (CIT) base. The taxable base is calculated by adjusting the accounting pre-tax profit shown in the taxpayer's financial statements by the tax base increasing (eg, accounting depreciation, non-deductible interest, creation of provisions, etc) and decreasing items (eg, tax depreciation, release of provisions, tax loss carry forwards, etc) prescribed in the Act on Corporate Tax and Dividend Tax (CDTA).

Minimum tax

Except in the pre-company period and in the first tax year of a company's existence (or in the first tax year if separate financial statements are not required for the pre-company period) and in some other defined cases, certain rules apply if the profit before taxation or the general CIT base (the higher of them) is below the minimum tax base. The minimum corporate tax base is calculated as 2% of the total revenue with some increasing and decreasing items (eg, transactions falling under the EU Merger Directive). In the above case, a company may decide to pay CIT based on the minimum tax base or may declare a statement in the CIT return in line with the Act on the Rules of Taxation. The statement provides additional details about the financials of the company, based on which the Tax Authority decides whether or not to initiate a tax audit.

Corporate income tax base

The taxable base of a real estate rich entity is calculated the same way as any other entity's, ie, accounting pre-tax profit adjusted by the tax base modifying items. In practice this means that the tax base of real estate holding entities equals to the gross income realised on operating the property and the proceeds from its sale, less allowable expenses, including repair, maintenance, tax depreciation, interest, building taxes, etc.

Foreign exchange (FX) gains and losses

In general, the FX is a common issue for real estate entities since the intercompany/bank loans and the rental fees are usually denominated in foreign currency (eg, in euro). Foreign exchange gains and losses realised on foreign currency denominated investment loans not covered with foreign currency held on account may be capitalised with the building. Further, unrealised FX differences (ie, FX gains and losses arising from the year-end revaluation of foreign currency denominated assets and liabilities) may be deferred for tax purposes until actual realisation.

Another option to treat FX exposure is by opting for a functional currency other than Hungarian forint. Under Hungarian GAAP (as opposed to IFRS), euro and US dollar may be used as functional currency without conditions. Other foreign currencies may be used if at least 25% of the company's (i) income, costs and expenses; and (ii) financial assets and financial liabilities – separately in the previous and in the current financial year – arise in those currencies.

Real property holding companies

The foreign owner of a real estate holding company is subject to Hungarian CIT in the case of the alienation or withdrawal of its shares in the real estate holding company.

The tax base of the foreign owner of a real estate holding company is the positive amount of the consideration received minus the acquisition price of the shares less the costs of the acquisition and the costs related to the holding of the shares. The tax rate is 9% and the participation exemption regulations do not apply.

A company and its Hungarian taxpayer related parties are defined as real estate holding companies for CIT purposes if:

- more than 75% of the book value of their assets (on a standalone and/or group level) is in domestic real estate; and
- they have a foreign shareholder that is not resident in a country that has a double tax treaty (DTT) with Hungary or the treaty allows such capital gains (from real property-rich shares) to be taxed in Hungary.

Hungary has concluded numerous DTTs in the past that provide treaty protection for such transactions. However, renewed DTTs usually allow for source country capital gains taxation in such cases.

Domestic shareholders are generally subject to 9% CIT on the above type of transactions. However, they may benefit from the Hungarian participation exemption regulations in the case of the alienation of the shares in, eg, a real estate holding company.

Interest on loans

Interest payable on loans borrowed for the acquisition and operation of real estate qualifies as allowable expense and is generally tax-deductible (apart from interest expenses subject to interest limitation rules, see later in detail). Interest due prior to the building being put into operation or accounted for as inventory is capitalised with the building and is deducted for tax purposes through depreciation.

Depreciation

Tax depreciation is established in general independently of the rate that is applied for accounting purposes. Tax depreciation rates for buildings in “own use” vary between 2% and 6% (usually 2% for long life buildings) of the acquisition cost, depending on the construction materials used. Leased buildings may be depreciated at an accelerated rate of 5% for tax purposes.

Taxpayers operating in the hospitality industry during the whole tax year may apply 3% accelerated depreciation for buildings made from long-life material and recorded amongst tangible assets provided that these assets are used for such an activity.

Lands cannot be depreciated (in the case of special circumstances extraordinary depreciation may be accounted for).

In the case of different depreciation rules allowed by the law in respect of the same asset, the taxpayers shall have the right to choose between the defined rates. The taxpayers are entitled to choose any depreciation rate for tax purposes that is between the accounting rate and the highest applicable tax depreciation rate by law.

Interest limitation

As per the rules effective until 31 December 2018, interest related to liabilities exceeding three times the equity (3:1 debt-to-equity ratio) is non-deductible for CIT purposes. When calculating the ratio, debts from financial institutions shall be disregarded and the amount of liabilities could be decreased by the amount of cash receivables (to exempt back-to-back financing from this rule). On the basis of the prior rules, the non-deductible amount of interest qualifies as a permanent tax base modifying item.

According to the new legislation, which is implemented on the basis of the EU Anti-Tax Avoidance Directive (EU ATAD) and entered into force in 1 January 2019, the non-deductible interest should be calculated using the tax EBITDA, instead of the debt-to-equity ratio. Based on the general rule, the net borrowing costs are deductible up to the higher of 30% of the tax EBITDA or 939,810,000 HUF. A major point of the amended law is that any interest paid to financial institutions will also be subject to the thin capitalisation rules.

For this purpose, tax EBITDA means an adjusted corporate tax base, ie, the current year's tax base modified with the net borrowing costs, tax depreciation, and utilisation of carried forward unused interest capacities/exceeding borrowing costs (if any).

On the basis of the EU ATAD, Hungary implemented certain derogation rules that could result in a higher interest deduction (i) if the taxpayer's group's equity/asset ratio or (ii) the net interest expense/tax EBITDA ratio is higher than the taxpayer's standalone respective ratio.

A grandfathering rule is also introduced, which states that in the case of loan agreements concluded prior to 17 June 2016, the old rules (ie, debt-to-equity approach) could be applied until there is no increase in the amount of debt, or the maturity date is not prolonged.

Participation exemption

As per the general rules, capital gains arising from the sale of shares are subject to CIT. Losses are deductible, accordingly.

The taxpayer has an election right to make within 75 days following the acquisition of the shares and this election must be reported to the Tax Authority. Once this election is made, the taxpayer is entitled to exempt future capital gains from CIT (including any FX gains). On the other hand, making this election will prohibit the deduction of any losses arising directly in connection with the shares (including impairments) for CIT purposes, but the deduction of the interest related to the acquisition of the shares is not affected by this rule. Failing to make the election within

75 days will result in losing the possibility for future capital gains tax exemption, ie, the election cannot be made later on and cannot be revised via self-revision.

The application of this rule requires that the shares are owned for at least one year without interruption following their acquisition. There is no minimum shareholding percentage requirement as of 1 January 2018.

Shareholdings in controlled foreign corporations (CFCs) cannot be reported to the Tax Authority thus the Hungarian participation exemption regime does not provide shelter for capital gain deriving from the sale of such shareholdings (the CFC definition is generally in line with that of the EU ATAD).

Shareholdings/investment units in a real estate investment fund (REIF) cannot be reported to the Tax Authority.

Treatment of dividend and capital reduction received

Dividend received from a subsidiary of a Hungarian entity is exempt from Hungarian CIT provided that the dividend is not received from a controlled foreign company and the payer does not expense it for tax purposes (ie, it is not a hybrid payment). Gains deriving from the capital reduction/ liquidation of a subsidiary may be tax exempt as well.

Corporate income tax non-deductible expenses

The major non-deductible expenses for CIT purposes, amongst others, are as follows:

- any cost/expense which does not serve the business purpose of the company;
- service fees, if the Hungarian company cannot support that the service was used in line with prudent management, ie, the activity performed does not provide the Hungarian company with economic or commercial value to enhance its commercial position;
- the portion of a price paid for a supply or provision of service by a related party exceeding the fair market value;
- interest on debts exceeding the maximum amount of deductible interest, as above;
- bad debt provision/impairment;
- debt write-offs if the measures necessary for collecting the debt have not been taken;
- expired debts and debts that cannot be enforced in the courts are not deductible;
- any depreciation applied for accounting purposes; and
- expenses/losses which derive from transactions having one of the main aims of achieving a tax benefit.

Tax losses carried forward

As a general rule, the negative tax base carried forward from previous years may decrease the CIT base up to 50% of the positive CIT base calculated without the utilisation of tax loss carried forward. Tax losses generated could be utilised in the next five tax years. However, losses generated before 2015 may be utilised until the tax year including 31 December 2030 provided that the negative tax base occurred under the principle of proper execution of the law within its meaning and intent.

Note that earlier tax losses must be used first (FIFO principle) and certain restrictions may be applicable in the case of ownership change and company transformations. If the activities and the profitability does not change significantly, restrictions are unlikely to be applicable.

There is no loss carry back for the real estate industry.

Special rules apply for CIT groups in Hungary.

Foreign entities' permanent establishment

A foreign person (except REIFs and pension funds which have their own legal personality, and are established in the EEA without being subject to or having to pay tax similar to the Hungarian CIT) may have a permanent establishment (PE) in Hungary, if it performs the following activities:

- using/utilising real properties or natural resources for certain fees; or
- transferring, contributing, selling property rights in connection with real properties and natural resources; or
- selling Hungarian real properties.

Group taxation for CIT purposes

As of 1 January 2019, taxpayers are able to opt for a group taxation regime for CIT purposes. Group taxation is available to affiliated companies resident in Hungary for tax purposes, provided that such affiliated companies have at least 75% direct or indirect control over each other, have the same year-end, and prepare their financial statements in the same way (as per Hungary GAAP or IFRS).

By opting for group taxation, group members are able to offset their operating losses up to 50% against the positive group tax base if certain conditions are met, as well as apply simpler transfer pricing rules to the intra-group transactions between the CIT group members.

Eligible group companies must submit an application to the Tax Authority between the first and 20th day of the month before the last month of the tax year in order to benefit from the group taxation regime for CIT purposes in Hungary. The procedural rules regarding the group taxation regime are included in the Act on the Rules of Taxation.

As from 24 July 2019, businesses that commence operations during the year can join existing corporate tax groups. Such businesses are deemed to become group members on the date on which they become subject to corporate tax in Hungary.

Hybrid mismatch rules and related anti-avoidance provisions

As from 1 January 2020, the respective provisions of the EU ATAD II (EU Directive 2017/952) had been incorporated to the Hungarian CIT legislation regarding hybrid mismatches in order to meet the implementation requirements as set out in the Directive.

For this reason, specific rules were introduced to tackle mismatches arising from transactions or revenue/expense recognition between hybrid entities (including hybrid branches). Even though Hungary did not implement more restrictive rules than prescribed by the EU ATAD II, the introduced legislation will require clarifications with the Tax Authority in some cases.

In the case of hybrid mismatches, the respective costs deductions must be denied, or the income shall be taken into consideration when calculating the tax base.

Exit taxation rules

Applicable from 1 January 2020, exit taxation provisions were introduced in the Hungarian CIT regime. The implementation of such rules serves the purpose to be in compliance with the harmonisation requirements of the EU ATAD I.

Accordingly, in certain cases (eg, in the case of transferring the effective place of management to a foreign jurisdiction, transferring assets to a foreign PE, etc) a Hungarian taxpayer is subjected to 9% CIT. The tax base equals to the positive difference between the fair market value of such assets (to be determined in line with the general transfer pricing guidelines) and the tax book value of those assets.

Note that asset relocations in the frame of a voluntary liquidation procedure is/was also covered by the Hungarian legislation.

Local taxes

Municipalities are authorised to impose local taxes and those that may affect a real estate business are local business tax, building tax and land tax. It is at the discretion of the particular municipality which of these taxes are imposed up to the maximum rates set by the Act on Local Taxes that applies to all municipalities.

Local business tax

Subject to the local municipalities' decision, on the basis of their business activities performed in the given municipality's jurisdiction, companies may be obliged to pay up to 2% local business tax calculated on their net sales revenues reduced by the cost of goods sold, the cost of mediated services, material costs and subcontractors' fee (in the cases of the first two deductions subject to certain limitations).

In addition to the aforementioned, royalty income is exempted from local business taxation and certain research and development costs may be deducted from the tax base. However, real estate ventures typically do not have items like the above in their accounting records thus, almost 100% of their net revenue is subject to local business tax. DTTs do not apply to local business tax except for the Polish-Hungarian and the Albanian-Hungarian DTT.

Building tax

Residential and other buildings may be subject to building tax, which is payable to the local municipality by the entity/individual owning the building on 1 January of the particular calendar year. If the property is encumbered with a registered user's right, the beneficiary of that right is required to pay the tax.

The local municipalities are entitled to levy this tax either on the basis of (i) the useable area of the building; or (ii) on the basis of the "adjusted value" (50% of the fair market value) of the building. In practice, the former method is more commonly used, since establishing the adjusted fair market value is usually problematic. The maximum rates are (i) 1,100 HUF/sqm (however, the municipalities have the right to increase it by the annual cumulated inflation rate, ie, the maximum tax rate is 1,951 HUF/sqm in 2020); or (ii) 3.6% of the market value of the building.

Land tax

The owner of the land on the first day of the calendar year is subject to land tax liability. Undeveloped plots of land situated within the area of jurisdiction of a local government, including peripheries, are subject to this tax. The local municipality is allowed to determine the tax base in either of the following ways:

- the actual area of the plot expressed in square metres, with a maximum tax rate of 200 HUF per square metre (however, the municipalities have the right to increase it by the annual cumulated inflation rate, ie, the maximum tax rate is 354 HUF/sqm in 2020);
- the adjusted market value of the plot, with a maximum tax rate of 3% of the adjusted market value.

Innovation contribution liability

Innovation contribution liability should be paid to the tax authority. The tax base for the innovation contribution liability generally equals the tax base for local business tax purposes. The applicable tax rate for innovation contribution liability is 0.3%. The innovation contribution has to be paid by all enterprises except for small enterprises. The thresholds (headcount number, the revenue and the balance sheet total) for small enterprises are calculated currently on a group level basis.

Withholding tax (WHT)

Based on domestic legislation payments (dividend, interest, royalty and service fees) made to entities are not subject to WHT in Hungary.

Value-added tax (VAT)

The standard VAT rate is 27% for goods and services. For certain residential development projects, a preferable 5% rate is also applicable, with full input VAT deduction right.

Option to charge VAT

Under the general rule, the sale of real estate, including certain types of lands (except construction land) is regarded as VAT-exempt with no option for tax deduction (the exemption may not be applicable if the building has not been put into operation or the sale takes places within two years from the date when the usage permit becomes effective). Lease of real estate is also VAT-exempt.

However, taxpayers may elect to make the above VAT-exempt sales and lease VATable. The deadline for submitting the statement for this option to the Tax Authority is the last day of the tax year prior to the tax year for which the company wishes to exercise this option or in certain cases prior to the date when the taxpayer starts certain business activity. The decision to treat a normally VAT-exempt transaction as VATable cannot be changed for five years upon the tax year following such a decision. The election can be made separately for commercial and residential properties.

VAT on the production/acquisition of tangible assets

Input VAT may be deductible on the purchase of tangible assets (eg, real estate) provided that the buyer has deduction right, ie, it performs VATable business activity (eg, it opts for VATable lease of the real estate property, etc).

Based on the Act on VAT in this case a so-called tangible asset monitoring/clawback period is triggered. The monitoring period is 240 months for real property and 60 months for other tangible assets and starts in the

particular month when the tangible asset is put into operation. This means that a company should monitor its VATable and non-VATable activities, and if the real estate property or other tangible asset is not used fully for VATable activity in a given year, then a part of the originally refunded VAT should be repaid (based on the ratio of the VATable and non-VATable activity of the company, maximum 1/20 or 1/5 of the originally deducted VAT per year) to the Tax Authority.

Obligation to pay VAT for services related to real estate

Many services and sales are subject to the reverse-charge mechanism and the VAT will be payable and deductible at the same time by the party acquiring the goods or services, provided that both the seller and the buyer are resident taxpayers and the buyer pays VAT according to the general rules.

This applies to, amongst others, construction and installation services and other services which are intended to create, develop real estate, provided that these services require official licences to be performed, and the sale of certain real estate provided that the seller opted for VATable tax treatment.

Invoicing in a foreign currency

In connection with rent and expenses set and invoiced in euro or another foreign currency, the amount of VAT must also be indicated in Hungarian forint in invoices made out in a foreign currency. Generally, foreign currency amounts should be converted at the selling rate of any resident (Hungarian) bank that holds a foreign exchange licence. Alternatively, taxpayers may also opt to apply the rate quoted by the National Bank of Hungary or the European Central Bank, subject to prior notice to the Tax Authority, with the provision that once this option has been chosen, no deviation is allowed until the end of the calendar year following the year in which the choice was made.

Transfer tax

Transfer tax on real properties

The applicable tax rate is 4% up to a tax base of 1 billion HUF (approx. 2.85 million EUR) and 2% above, but it is capped at 200 million HUF (approx. 570,000 EUR). The above caps and thresholds apply by real estate properties (ie, by plot numbers).

This tax is payable by the person (company) acquiring the real property and is assessed on the fair market value of the property (gross asset value). The tax is levied both on land and on completed buildings. Real estate transfer tax is payable to the Tax Authority upon notification.

Transfer tax exemption may be claimed between related parties if the acquirer's principal activity at the time when the taxable event takes place is the leasing or management of own or leased property or buy/sale of own properties. In the case of a foreign buyer, additional requirements may be required to be fulfilled in order to benefit from the tax exemption.

Reduced rates of 2%/3% apply if the company acquiring the property qualifies as a real estate trading company, or it deals with financial leasing, and the property is sold/leased out within two years.

REIFs may also benefit from a reduced transfer tax rate of 2%. Note that in the case of REIFs the above 200 million HUF (approx. 570,000 EUR) cap per plot number cannot be applied.

Acquisition of land for the development of residential property is exempt from transfer tax if the construction of the residential property is completed within four years and the basic area of the residential property reaches at least 10% of the maximum built-in rate.

The transfer of certain real property-related rights (ie, different forms of user's rights) is also subject to transfer tax. The taxable base is, in general, equal to one-twentieth of the fair market value of the property to which the right relates, multiplied by the number of years for which the right prevails. In certain cases, special calculation method may be applicable.

Transfer tax on the acquisition of domestic real estate rich company's shares

Under Hungarian law the acquisition of existing and outstanding shareholding in an entity qualifying as a real estate rich company for transfer tax purposes is subject to transfer tax. The transfer tax payment obligation lies with the acquirer, but it only arises when the acquirer, as a result of the acquisition, holds (alone or together with its related parties) a shareholding reaching at least 75% in the real estate rich company.

Any company is considered to be a real estate rich company, if the Hungarian real estate properties it owns represent more than 75% of its adjusted balance sheet total (balance sheet total reduced by cash, cash equivalents, etc, all calculated at book value) or has at least 75% direct or indirect ownership in such a company. The ratio has to be determined on the basis of the latest available financial statements at the date of the transaction.

The base of the transfer tax is the fair market value (FMV) of the Hungarian real estate properties directly, indirectly (in at least 75%) owned by the real estate rich company pro rata to the direct, indirect ownership acquired.

The applicable tax rate is 4% up to a tax base of 1 billion HUF (approx. 2.85 million EUR) and 2% above, but it is capped at 200 million HUF (approx. 570,000 EUR). All the above thresholds and caps apply per real estate properties, ie, per plot numbers.

Transactions between related parties may be exempt from the transfer tax, subject to conditions.

Real estate investment trust (REIT)

Hungarian REITs are public listed companies which are registered with the Hungarian National Tax Authority. REITs must have a registered seat in Hungary or in any other Member State of the European Economic Area and REITs must be listed on at least one stock exchange or regulated stock market operating in the European Union. Upon registration, at least 25% of the shares of the REIT must be available to the public for trading (free-float).

Investors may include both small investors and institutional investors, but credit institutions and insurance companies should not have directly more than 10% voting rights.

REITs may own and operate their real estate portfolio directly, or alternatively, through their 100% owned companies (“project companies”). The activities of REITs may include sale of real estate, lease of real estate, management of real estate, development of real estate for own use, and the organisation of real estate development projects.

At least 70% of a REIT’s total assets must consist of immovable property (at fair value), while the level of their debt financing may not exceed 65% of the real property value as shown in the consolidated or the individual financial statements prepared under HU GAAP or IFRS.

REITs may keep their books either under Hungarian GAAP or under IFRS (even on standalone level).

In terms of taxation, REITs (and “project companies”) are exempted from corporate income tax (which is otherwise 9% of the adjusted pre-tax profit) and local business tax (which otherwise may be levied up to 2% of the adjusted net sales revenue by local municipalities).

Additionally, reduced transfer tax rate of 2% is applicable for the acquisition of real estates, property rights related to real estates and real estate rich entities by REITs (instead of the general 4%/2% regressive rate).

Distributions by REITs to foreign or Hungarian entities are not subjected to Hungarian WHT.

Hungarian or foreign resident private individuals are subject to 15% personal income tax withheld at source on distributions made thereto (in the latter case a reduced treaty rate may apply).

Provided the REIT is listed on a recognised stock exchange, no Hungarian capital gains taxation shall arise on the alienation of REIT’s shares by foreign investors.

Real estate investment fund (REIF)

Background

Pursuant to Hungarian legislation (Act XVI of 2014), real estate investment funds are collective investment vehicles with legal personality, not operating in a corporate form. Rather, they are unincorporated asset funds where all the investment decisions are made by the fund manager in the name and on behalf of the fund. Fund managers incorporated in Hungary have to operate in the form of a company limited by shares and are subject to strict regulatory requirements.

Real estate investment funds can be public investment funds whose units are offered to the public or private funds. They can have a definite or indefinite duration and can be structured as closed-end or open-end funds (based on whether redemption of its units is possible during the fund’s term).

Regulation

The National Bank of Hungary is the responsible body for the licensing and supervision of Hungarian investment funds and fund managers incorporated in Hungary.

Minimum level of initial capital

The minimum initial capital is 1 billion HUF (approx. 2.85 million EUR) for public, and 500 million HUF (approx. 1.42 million EUR) for private real estate investment funds.

In terms of the fund manager, it is authorised to pursue real estate investment fund management activities with at least 300,000 EUR initial capital.

Permitted assets and investment restriction

The primary permitted assets a real estate investment fund may invest in are properties which can be located in Hungary or outside Hungary. They are allowed to invest in a quite broad spectrum of other permitted assets, including for example certain qualifying securities offered to the public qualifying derivatives and investments in real estate holding SPVs (subject to holding thresholds and compliance by the SPV with certain investment restrictions). Private REIFs may also invest in qualifying rights and interests in real estate properties (eg, usage rights in rem).

In the case of public real estate funds, real estate portfolio diversification requirement applies (eg, the value of a single real estate property may not exceed 20% of the total assets in the case of open-end public funds and 30% in the case of closed-end public funds). Investments in other permitted assets are also subject to diversification requirements and the gearing ratio is capped at 60%. In the case of private funds such statutory restrictions do not apply, however, they need to comply with the investment restrictions set out in their investment policy and they are also required to set up diversification requirements, investment limits and liquidity management like all other alternative investment funds.

Real estate properties and connected rights held (directly or indirectly) by real estate investment funds are subjected to independent valuation obligation every six months. In the case of real estate properties under construction, the valuation obligation applies every three months.

Tax treatment of a REIF

Corporate income tax

Real estate investment funds are not liable to pay corporate income tax (the rate of which otherwise is 9% for companies). On the other hand, generally funds are not considered to have access to DTTs.

Local business tax

Real estate investment funds do not qualify as taxpayers in the sense of local business tax (the rate of which for companies is otherwise up to 2% of the adjusted net sales revenue).

Real estate transfer tax (RETT)

Purchasing of real estate property or real estate rich entity in Hungary is subject to RETT in the hands of the buyer. The general rate is 4% of the FMV of the real estate property up to 1 billion HUF (approx. 2.85 million EUR), and 2% for the exceeding part, while the tax is capped at 200 million HUF (approx. 570,000 EUR) per real estate.

In the case of acquisition by real estate investment funds, the tax rate is flat 2%, however, no cap applies.

Special tax

Real estate investment funds have to pay yearly 0.05% special tax on the basis of their net asset value.

Value-added tax (VAT)

Per the Hungarian rules, no specific VAT legislation has been enacted in the case of real estate investment funds thus, the general rules have to be applied.

Foreign investors' taxation

Per Hungarian domestic legislation, there is no WHT on distributions/payments made to entities. Thus, foreign entity investors can realise the fund's proceeds WHT-free.

In the case of foreign investors, Hungary operates source country capital gains taxation only with respect to real estate rich companies (subject to treaty override). However, in the case of real estate investment funds such taxation does not apply even without treaty protection, since the rules only capture the profit realised in terms of real estate rich companies (and not via real estate investment funds).

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Real Estate Going Global

India

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2020

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All information used in this content, unless otherwise stated, is up to date as of 30 July 2020.

Real Estate Tax & Regulatory Summary

General

A foreign investor is not permitted to invest directly in an immovable property in India. However, this restriction does not apply to a non-resident Indian (NRI), Overseas Citizen of India (OCI) and a foreign company acquiring immovable property (through a branch or project office or other place of business in India) for carrying out its business activities. However, a foreign investor (financial and strategic investor) can invest in permitted securities of an Indian company undertaking construction and development of real estate projects (subject to certain conditions provided under the foreign direct investment policy of India). Foreign investment is also permitted in Special Economic Zones (SEZs) and industrial parks.

The Indian regulators have brought about amendments to Indian Exchange Control Regulation as well as tax laws which has led to opportunities for real estate investment trusts (REITs). The efforts of the regulators have yielded results since REIT market in India has captured the attention of various investors.

Applicable taxes

Rental income

Under the Indian Income-tax Act, 1961 (Act), rental income from immovable property can be characterised either as “business income” or “income from house property”.

In case the income is characterised as “business income”, it would be taxable at the applicable tax rate to domestic companies. The applicable tax rate is 30%[1] (plus applicable surcharge and cess) after allowing deduction of all permitted business expenses for a domestic company. The said rate will be reduced to 22% (plus applicable surcharge and cess) on a net basis in case the said company does not claim specific tax holidays, deductions and exemptions and complies with prescribed conditions.

In case income is characterised as “income from house property”, such income would be taxable as per the applicable tax rate for a domestic company after allowing a standard deduction and other specified deductions (viz. property tax, interest expense) under the Act. The income computation mechanism under both the above heads of income would be different.

Tax incentives are available for certain projects in the real estate sector, eg, affordable housing projects, slum redevelopment, development, building and operating hotel, operation and maintenance of specified infrastructure facilities, etc.

Capital gains

Capital gains earned on transfer of immovable property (ie, not held as stock-in-trade) are taxable as follows:

Holding period	Tax rates (%)*
Up to 24 months	Applicable tax rates
More than 24 months	20

* to be increased by applicable surcharge and cess

Sale of immovable properties without consideration or nominal consideration may be subject to taxation both in hands of the transferor (ie, as notional capital gains) as well as in the hands of the buyer (ie, as notional income under head “income from other sources”). For purpose of computing the consideration to be adequate or not, the

[1] In case of an assessee being a domestic company whose turnover or gross receipts is within the prescribed limit (prescribed turnover is less than or equal to 400 Indian rupees (INR) cr for FY 2018-19), the rate of tax would stand reduced to 25% vis-à-vis 30% (plus applicable surcharge and cess).

same would be compared with the fair market value (FMV) as per the prescribed methodology. However, safe harbour of 10% is allowed where the consideration is less than the FMV.

Capital gains earned on transfer of unlisted securities[2] is taxable as follows:

Holding period	**Tax rates (%)***	
	Resident	Non-resident
Up to 24 months	Applicable tax rates	40
More than 24 months	20	10

* to be increased by applicable surcharge and cess

Capital gains earned on transfer of the specified[3] listed securities (ie, not being held as stock-in-trade) transferred on the recognised stock exchange in India, is taxable as follows:

Holding period	**Tax rates (%)***
Up to 12 months	15
More than 12 months	10

* to be increased by applicable surcharge and cess

The law provides for anti-abuse provisions for transfer of unlisted securities for no consideration or inadequate consideration. Similarly, there are anti-abuse provisions for receipt of securities for nominal or inadequate consideration. For purpose of computing the consideration to be adequate or not, the same would be compared with FMV to as per the prescribed methodology.

Minimum alternative tax (MAT)

Where the tax liability of an Indian company, computed in the prescribed manner, is less than 15% of the adjusted book profits of the company, MAT at 15% (plus applicable surcharge and cess) is payable by the Indian company. However, the same shall not be applicable to a company opting for concessional tax rate of 22% as stated above.

[2] As per section 2(h) of the Securities Contracts (Regulation) Act, 1956, “securities” include shares, scrips, stocks, bonds, debentures, debenture stock or other marketable securities of a like nature in or of any incorporated company or other body corporate.

[3] equity share in a company or a unit of an equity oriented fund or a unit of a business trust

Real Estate Investments

Regulatory

Direct investments in real estate property

NRI and OCI are permitted to acquire any immovable property in India other than agricultural land, plantation property, or farmhouse property.

A foreign company is not permitted to directly hold any immovable property in India. However, as an exception, a foreign company (through a branch or project office or other place of business in India) is permitted to acquire any immovable property in India, for carrying on its business activities.

Foreign direct investments (FDI) in real estate

FDI in real estate business is generally prohibited. Further, FDI is prohibited in an entity engaged in dealing in land and immovable property, construction of farmhouses and trading in transferable development rights. Real estate business is defined under the Non-Debt Instrument Rules as follows:

"'Real estate business" means dealing in land and immovable property with a view to earning profit therefrom and does not include development of townships, construction of residential/commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, and townships.

Further, following activities shall be excluded from the definition of the real estate business being:

- investment in units of REITs registered and regulated under the Securities Exchange Board of India's (SEBI) REITs Regulations 2014;
- earning of rent income on lease of the property, not amounting to transfer, shall not amount to real estate business; and
- real estate broking services and 100% foreign investment is allowed in real estate broking services under automatic route.

The term, "transfer" has been defined, among other things, it also includes any arrangement having the effect of transferring or enabling enjoyment of immovable property.

100% FDI in construction and development projects is permitted under the automatic route.

The said investment is subject to certain investment and project-related guidelines, being as follows:

- Each phase of the construction development project would be considered as a separate project.
- The foreign investor is permitted to exit and repatriate foreign investment on completion of project or trunk infrastructure or completion of a lock in period of three years, whichever is earlier. Lock in period shall be calculated with respect to each tranche of foreign investment. Lock in condition is not applicable in case of transfer of stake from one non-resident to another non-resident.
- The project shall conform to the norms and standards as laid down in the applicable regulations of the State Government or Municipal or Local Body concerned. The Indian investee company shall be responsible for obtaining all necessary approvals and compliance with all other requirements.
- The Indian investee company shall be permitted to sell only developed plots. The term "developed plots" is defined as plots where trunk infrastructure, ie, roads, water supply, street lighting, drainage and sewerage, have been made available.
- 100% FDI under automatic route allowed in completed projects for operation and management of townships, malls/shopping complexes and business centres, subject to a lock in period of three years. Lock in period shall be calculated with respect to each tranche of foreign investment and transfer of immovable property or part thereof is not permitted during this period.
- FDI is permitted under the automatic route without being subject to lock-in conditions in case of development of SEZs, hotels and tourist resorts, hospitals, educational institutions, old age homes and investment by NRIs/ OCIs.

- FDI is also allowed up to 100% in industrial parks under the automatic route. The conditions specified above (ie, lock-in period, etc) would not apply provided the industrial park meets the prescribed conditions in terms of minimum number of units, allocable area conditions for units and industrial activity, etc.

Under the FDI route, a person resident outside India is allowed to invest in equity instruments. Equity instruments has been defined to include the following:

- equity shares, including partly paid up shares. However, such partly shares are required to be fully called-up within 12 months of such issue or as may be specified. In addition, 25% of the total consideration amount (including share premium, if any) is required to be received upfront;
- fully, compulsorily and mandatorily convertible debentures;
- fully, compulsorily and mandatorily convertible preference shares;
- share warrants - 25% of the consideration is required to be received upfront and the balance amount within 18 months of the issuance of such share warrants.

Further, equity instruments can contain an optionality clause subject to a minimum lock-in period of one year or as prescribed for the specific sector, whichever is higher, but without any option or right to exit at an assured price.

Regarding the Non-Debt Instrument Rules, the government has provided guidelines for:

- calculation of total foreign investment – ie, direct and/or indirect foreign investment in Indian entity;
- pricing in case of issue/transfer of any capital instruments by the Indian entity to person resident outside India or any transfer of capital instrument by the person resident outside India to the Indian resident or vice versa.
- downstream investments by Indian entities (ie, which has FDI) further into other Indian entities.

FDI is permitted to contribute to the capital of a Limited Liability Partnership (LLP) operating in sectors/activities where foreign investment up to 100 percent is permitted under automatic route and there are no FDI linked performance conditions.

Regulations specific to FPIs

A SEBI registered Foreign Portfolio Investor (FPI) can invest in listed or to be listed equity instruments, subject to certain conditions.

FPIs are also permitted under General Investment Route (GIR) to invest in listed/unlisted NCDs issued by Indian company subject to conditions relating to the maturity period of the instruments and the amount. Unlisted NCDs are subject to minimum residual maturity of one year and have an end use-restriction on investment in real estate business, capital market and purchase of land.

In addition to the GIR, the Reserve Bank of India (RBI) had introduced the Voluntary Retention Route (VRR) for FPIs investment in debt. Key features are discussed below:

- invest 75% of committed size within three months;
- no minimum residual maturity prescribed. However, minimum retention period is three years; Post-completion - option to hold until maturity or date of sale, whichever is earlier;
- flexibility to repatriate interest income any time; 25% of committed portfolio size could be repatriated at any time;
- the investment limits available “on tap”/auction and allotted on “first come, first served” basis; and
- transfer from GIR to VRR route allowed, at the discretion of FPI.

External commercial borrowings (ECBs)

Under the extant ECB framework, ECBs are defined as commercial loans raised by eligible resident entities from recognised non-resident entities and should conform to parameters such as minimum maturity, permitted and non-permitted end-uses, maximum all-in-cost ceiling, etc. The parameters given below apply in totality and not on a standalone basis.

All eligible borrowers can raise ECB up to 750 million USD or equivalent per FY under the automatic route.

All entities eligible to receive FDI qualify as eligible borrower. The recognised lenders are as follows:

- resident of Financial Action Task Force (FATF)[4] or International Organisation of Securities Commission (IOSCO)[5] compliant country, including on transfer of ECB;
- multilateral and regional financial institutions where India is a member country;
- Individuals can only be permitted if they are foreign equity holders or for subscription to bonds/debentures listed abroad.
- Foreign branches/subsidiaries of Indian banks are permitted as recognised lenders only for FCY ECB (except Foreign Currency Convertible Bonds and Foreign Currency Exchangeable Bonds). However, underwriting by foreign branches/subsidiaries of Indian banks for issuances by Indian banks will not be allowed.

Minimum average maturity (MAM):

MAM for ECB will be three years (except for specific categories like manufacturing companies, working capital purposes, etc). The same applies to exercise of call and put option as well, if any.

All-in-cost:

The all-in-cost requirement for ECB covered shall be maximum spread of 450 basis points over the benchmark.

The other costs like prepayment charge/penal interest, if any, for default or breach of covenants, should not be more than 2% over and above the contracted rate of interest on the outstanding principal amount and will be outside the all-in-cost ceiling.

Permitted end-use for all ECB - any end-use other than the following:

- real estate activities;
- investment in capital market;
- equity investment; and
- working capital purposes, general corporate purposes, repayment of rupee loans, on-lending to entities for the above activities unless the ECB is raised from foreign equity holder.

Real estate activities is defined as any real estate activity involving own or leased property, for buying, selling and renting of commercial and residential properties or land and also includes activities either on a fee or contract basis assigning real estate agents for intermediating in buying, selling, letting or managing real estate.

However, the same does not include the following:

- construction/development of industrial parks/integrated townships/SEZ;
- purchase/long term leasing of industrial land as part of new project/modernisation of expansion of existing units; and
- any activity under “infrastructure sector” definition.

Optionally convertible or redeemable preference shares or debentures would be considered as ECB, thereby requiring compliance with ECB norms.

Regulations specific to NRIs

NRIs are permitted to make investment through an overseas trust, company or partnership firms owned and controlled by the NRIs and can avail benefits that are available for NRIs making investment in their individual capacity, in construction development sector.

Acquisition and transfer of immovable property by NRI/OCI other than by way of gift or inheritance to be as follows:

- NRI and OCI are permitted to acquire any immovable property in India other than agricultural land, plantation property, or farmhouse property from the following sources:
  - funds received in India through normal banking channels by way of inward remittance from any place outside India; and

[4] A country that is a member of the FATF or a member of a FATF-Style Regional Body; and should not be a country identified in the public statement of the FATF as (i) A jurisdiction having a strategic Anti-Money Laundering or Combating the Financing of Terrorism deficiencies to which counter measures apply; or (ii) A jurisdiction that has not made sufficient progress in addressing the deficiencies or has not committed to an action plan developed with the Financial Action Task Force to address the deficiencies.

[5] A country whose securities market regulator is a signatory to the IOSCO’s Multilateral Memorandum of Understanding (Appendix A Signatories) or a signatory to bilateral Memorandum of Understanding with the SEBI for information sharing arrangements.

  - funds held in any non-resident account maintained in accordance with the provisions of exchange control laws.

- Exchange control laws also permit transfer of the above properties, subject to restrictions.

  Repatriation of sale proceeds on transfers of immovable property by NRI/OCI if acquired out of foreign currency shall be permitted, provided certain conditions are satisfied, inter alia, including the following:

  - The immovable property was acquired in accordance with the provisions of the foreign exchange law in force at the time of acquisition.
  - The amount paid for acquisition of the immovable property was received in foreign exchange through normal banking channels or out of the funds held in a Foreign Currency Non-Resident Account (FCNR) account or Non-resident External (NRE) account.
  - In the case of residential property, the repatriation of sale proceeds is restricted to the proceeds from not more than two such properties.

- NRIs/Persons of Indian Origin (PIOs) are permitted to remit up to 1 million USD per financial year (FY) on account of sale proceeds of assets (including immovable property) on production of documentary evidence in support of acquisition of assets in India and discharge of appropriate Indian taxes. NRIs/PIOs can freely repatriate rental income from such properties through the banker/authorised dealer.
- NRIs/OCIs are freely allowed to invest in companies listed on Indian stock exchanges on repatriation basis subject to fulfilment of inter alia the following conditions:
  - The purchase and sale are done through a designated authorised dealer branch.
  - The total holding by any individual NRI or OCI should not exceed 5% of the total paid-up equity capital on a fully diluted basis or should not exceed 5% of the paid-up value of each series of debentures or preference shares or warrants issued by an Indian company.
  - Further, the total holdings of all NRIs and OCIs put together should not exceed 10% of the total paid-up equity capital on a fully diluted basis or should not exceed ten percent of the paid-up value of each series of debentures or preference shares or warrants.
  - The aggregate ceiling of 10% can be raised to 24% if a special resolution to that effect is passed by the General Body of the Indian company.
- Investment in equity instruments/units of an investment vehicle (includes units of REIT)/LLPs/partnership or proprietary firm can be made without any limit by NRI/OCI directly or indirectly (ie, through a company, a trust, etc incorporated outside India but owned and controlled by said NRI/OCI) on non-repatriation basis. Said investment would be deemed to be treated as domestic investments (ie, at par with the resident investor). Accordingly, the conditions regarding lock in period, pricing guidelines, etc would not apply in that case.
- NRIs/OCIs can invest in units of domestic mutual funds on non-repatriation basis which invest more than 50% in equity without any limit.

Prohibition of investment in Nidhi Company or a company engaged in agricultural/plantation activities or real estate business or construction of farmhouses or dealing in transfer of development rights.

Real estate investment trust (REIT)

REIT is an investment vehicle that owns and operates real estate related assets and allows individual investors to earn income produced through real estate ownership without actually having to buy any such assets.

Typically, income producing real estate assets owned by a REIT include office buildings, shopping malls, apartments, etc.

The salient features of REITs are:

- A REIT is required to be constituted as a trust.
- There is no maximum limit as to number of sponsors.
- A REIT needs to be registered with SEBI.
- The sponsors collectively should have a net worth of not less than 1,000 million INR and individually not less than 200 million INR.
- Sponsors or its associates to have minimum experience of five years in the development of real estate or real estate fund management.
- Developer sponsors to have a track record of at least two completed projects.

- The manager of the REIT should have a minimum net worth of 100 million INR.
- The manager or its associates to have minimum experience of five years in fund management, advisory or property management in the real estate sectors in real estate development.
- It is mandatory for all units of a REIT to be listed on a recognised stock exchange in India.
- At the time of initial offer, value of the assets owned by a REIT should be at least 5,000 million INR and the minimum offer size (2,500 million INR being the minimum) would depend upon overall post-issue capital.
- The sponsor should hold a minimum of 5% units in a REIT individually.
- The sponsor should hold a minimum 25% units (on post issue basis) in a REIT. The same would be subject to lock in of three years after initial offer. Units exceeding 25% shall be subject to a lock in of one year after initial offer.
- The minimum number of unit holders (other than sponsor, its related parties and its associates) forming part of public shall exceed 200.
- The maximum subscription from any investor (other than sponsor, its related parties and its associates), its related parties and its associates cannot exceed 25% of the total unit capital.
- A REIT can invest either directly in or indirectly in real estate assets in India.
- A REIT must distribute at least 90% of its net distributable cash flows to the unit holders.
- REITs are prohibited from investing in vacant land or agricultural land or mortgages. However, investment in vacant land is permitted where the land is contiguous, and an extension of the existing project being implemented in stages.
- At least 80% of a REIT should be represented by completed and rent/income generating assets.
- Maximum of 20% of the value of a REIT can be represented by – under construction properties, listed or unlisted debt of real estate companies, mortgaged backed securities, equity of listed Indian companies and government securities.
- At least 51% of the revenue should be from rental or leasing of assets, or incidental revenue; and
- Investment in other REITs or lending is not permitted.

Regulatory framework

- Foreign investment is permitted in REITs.
- Persons resident outside India, including NRI, have been permitted to invest in units of REITs.
- Sale/transfer/pledge of units is permitted in REITs.
- Such investments can be transferred or sold in any manner or redeemed as per SEBI regulations/RBI directions.

Are investments by REITs treated as a foreign investment?

Investments by a REIT shall be regarded as foreign investment only if either a sponsor, or a manager, or an investment manager[6], is not Indian “owned and controlled”. If such investments are treated as foreign owned, they would need to comply with the applicable sectoral caps and other restrictions.

For this purpose, ownership and control of companies and LLP are to be determined in accordance with the regulations prescribed. For entities other than companies or LLPs, SEBI shall determine whether or not the entity is foreign owned and controlled.

Procedural conditions

The payment for the units of an REIT are to be made by an inward remittance through normal banking channels, including by debit to an NRE or an FCNR account. REITs will have to report to RBI or SEBI in the prescribed format.

[6] A sponsor, manager, or investment manager can be organised in the form of an LLP.

Real Estate (Regulation and Development) Act, 2016

The Real Estate (Regulation and Development) Act, 2016 ("the Real Estate Act"), that seeks to protect the interests of the large number of aspiring buyers and to promote transparency, accountability and efficiency in the sector. The Real Estate Act seeks to put in place an effective regulatory mechanism for orderly growth of the sector. Some key highlights of the Real Estate Act are as follows:

- obliges the developer to park 70% of the project funds in a separate bank account;
- all project measuring more than 500 square metres, or more than eight apartments will have to be registered with the Regulatory Authority to be prescribed in this regard;
- projects under construction are required to be registered with the Regulatory Authority to be prescribed in this regard;
- both consumers and developers to pay the same interest rate for any delays on their part;
- liability of developers for structural defects have been increased from two to five years;
- change in plans requires consent of the allottees;
- insurance of land titles;
- specific and reduced time frames for disposal of complaints by the Appellate Tribunals and Regulatory Authorities to be prescribed in this regard.

Tax

The main taxes related to transactions in real estate are summarised in the subsequent paragraphs.

Corporate tax

The profits of an Indian company are subject to the tax rate of 30%[7] (plus applicable surcharge and cess) after allowing deduction of all permitted expenses. The said rate will be reduced to 22% (plus applicable surcharge and cess) on a net basis in case the said company does not claim specific tax holidays, deductions and exemptions and complies with prescribed conditions.

Where the computed tax liability is less than 15% of the adjusted book profits of the company, MAT would be payable on the adjusted book profits at rate of 15% (plus applicable surcharge and cess). However, the same shall not be applicable to a company opting for concessional tax rate of 22%.

The manner of taxation for an Indian company engaged in real estate sector depends on the nature of the activity carried out by the company.

Build to sell model

Indian companies engaged in development and construction of residential projects, typically, follow "build to sell" model.

Income from sale of property is characterised as business income and taxable at applicable rates, on a net income basis. Development cost (excluding borrowing costs) incurred to develop the property is considered as part of inventory and allowed as deduction in a phased manner in line with accounting policy followed by the company. However, with enactment of the Income Computation and Disclosure Standards (ICDS), the borrowing costs would be required to be capitalised to the inventory as per the formula provided in the said ICDS depending on the borrowing being in nature of specific borrowing or general borrowing.

Further, with effect from 1 April 2018, the companies following Indian Accounting Standards (Ind-AS), would be required to be recognise the revenue and related expenses based on the "project completion" method vis-à-vis the percentage completion method generally followed.

[7] In case of an assessee being a domestic company whose turnover or gross receipts is within the prescribed limit (prescribed turnover is less than or equal to 400 INR cr for FY 2018-19), the rate of tax would stand reduced to 25% vis-à-vis 30% (plus applicable surcharge and cess).

Build to lease model

Indian companies engaged in development of office space, eg, SEZ development follow “build to lease” model. Certain Indian companies also follow hybrid models, eg, retail assets, where it could be combination of fixed lease and revenue share of the tenants.

The taxability under “build to lease” model would largely depend on facts of each case. In a case where the primary objective of the Indian Company is to lease property together with provision of other related facilities/amenities, it should be characterised as business income and would be taxed in a manner similar to “build to sell” model. However, in this case, the borrowing cost incurred to develop the property is capitalised and depreciation allowance can be claimed by the Indian company on the same.

In case, the Indian company earns rental income from plain vanilla leasing and where leasing is not the main object of the Indian Company, such rental income is characterised as “income from house property”. There is a specific tax computation mechanism prescribed to determine the taxable income of such companies. The tax law provides for standard deduction of 30% of gross rental income in addition to interest expense and property taxes on actuals.

Characterisation of income earned by an Indian company engaged in earning rental income from leasing activity has been a matter of debate and subject to litigation. The tax authorities, in order to bring more certainty and clarity on this aspect, the Circular[8] has stated that income from Industrial Park/SEZ established under various schemes framed and notified under the Act is liable to be treated as income under the head “profits and gains from business and profession”.

Income Computation and Disclosure Standards (ICDS)

The CBDT has notified[9] ten ICDS. The same would be applicable to the assessee following mercantile basis of the accounting and computing income under the head “profits and gains from business or profession” or “income from other sources”. ICDS income tax were issued with the aim of bringing uniformity in accounting policies governing computation of income in accordance with tax related provisions, and also reducing the irregularities amongst them. Accordingly, certain ICDS relating to inventory, provisions, service income, borrowing costs, retained monies, etc would have implications in computing income.

Further, draft ICDS in respect of real estate transaction and leases were also issued in May 2017, however same are awaited to be notified.

Sale of properties

Sale of properties held as capital assets (ie, not developed or held with purpose of selling), is taxable as capital gains as follows:

Holding period	Tax rates (%)*
Up to 24 months	Applicable tax rates
More than 24 months	20

* to be increased by applicable surcharge and cess

Valuation of the FMV of the unquoted securities

The FMV of the unquoted equity shares would be equivalent to the modified net worth of the company, wherein the value of specified assets would be replaced by value as prescribed in order to arrive the FMV (for eg, book value of immovable property would be replaced by values imputed for stamp duty purposes). In case of any other unquoted securities, the FMV would be as per the valuation report obtained from the merchant banker.

In case, the transfer of the securities is done below the prescribed FMV, then differential amount would be taxed as notional capital gains in hands of the transferor. Similarly, in hands of the recipient if the consideration paid to acquire the securities is less than the FMV prescribed, the shortfall would be taxable as notional income under head “income from other sources” in hands of the recipient.

8 Circular dated 25 April 2017
9 Notification No 87/2016 dated 29 September 2016

Anti-abuse provision

Sale of immovable properties held as capital asset or stock-in-trade without consideration or nominal consideration may be subject to taxation at a deemed value (usually determined based on the values imputed for stamp duty purposes) in hands of the transferor as notional capital gains or notional profits respectively. Further, the buyer acquiring said immovable property for inadequate consideration would also be subject to tax on differential amount under head “income from other sources” at the applicable tax rate.

Further, no adjustments shall be made in a case where the variation between stamp duty value and the sale consideration is not more than 10% of the sale consideration.

Corporate restructuring

Transfer of properties which may occur by way of corporate restructuring (such as amalgamations, demergers, etc) could be tax neutral subject to conditions.

Tax incentives

Investment linked tax incentives are available for certain asset classes (such as certain affordable housing projects, slum redevelopment projects, hotels meeting certain criteria, etc). However, there is a plan to phase out certain Income-tax incentives with a view to bring down the overall corporate tax rate.

Minimum alternative tax (MAT)[10]

Where the tax liability of an Indian company, computed in the prescribed manner, is less than 15% of the adjusted book profits of the company, tax would be payable on the book profits at rate of 15% (plus applicable surcharge and cess) by the Indian company.

MAT credit is available to be carried forward for 15 years.

Depreciation allowance under tax laws

Depreciation allowance at rates varying between 5% and 10%, depending upon the type of building, is allowed against business income for buildings used by a person in their own business, and not leased out. If the person is in the business of leasing and the rental income is characterised as business income, then depreciation is allowed for tax purposes.

Generally, the basis of depreciation is a written-down value (WDV) of a building. Land is not depreciable. The law prescribes the rates at which depreciation is to be calculated on block of assets (BoA). Under this method, depreciation is not allowed on any individual asset but is calculated on the BoA. On purchase of an asset belonging to a particular BoA, it is added to the BoA at cost. Similarly, the consideration received on sale of asset is reduced from the said BoA. When such consideration received exceeds WDV of the BoA, the negative BoA value is chargeable to tax as income in the year of sale under the head “capital gains”.

Taxation of REITs

Tax treatment at REIT level

Any income by way of interest (interest income)/dividend (dividend income) received from the special purpose vehicle (SPV), or by way of renting or leasing or letting out any real estate asset owned directly by the REIT (lease rent) should be exempt from tax in the hands of the REIT and would be liable to tax in the hands of the unit holders.

However, the SPV is required to withhold tax at the rate of 10% on dividend income paid to the REIT.

Further, share of profit, as the case may be, is exempt from tax as well, in the hands of the REIT.

[10] MAT provisions would not be applicable in case of companies opting for a concessional tax rate of 22% (plus applicable surcharge and cess).

Gains on transfer of the securities[11] in the SPVs or real estate assets held by the REIT, should be subject to capital gains tax in hands of the REIT as follows:

Holding period	Tax rates (%)*
Up to 24 months	30
More than 24 months	20

* to be increased by applicable surcharge and cess

Withholding tax on distributions

Resident investors

Where the REIT distributes the income received by it, by way of interest from the SPVs or lease rentals, to a resident unit holder, the REIT is required to withhold tax at the rate of 10%. Further, the REIT is required to withhold tax on dividend at the rate of 10% only in case the SPV has opted for a concessional tax regime[12]. No withholding tax is required on dividend income in case the SPV has not opted for a concessional tax regime.

Non-resident investors

Where the interest income, received by the REIT, is distributed to a non-resident unit holder, the REIT is required to withhold tax at the rate of 5% (plus applicable surcharge and cess).

Where the dividend income, received by the REIT, is distributed to a non-resident unit holder, the REIT is required to withhold tax at the rate of 10% (plus applicable surcharge and cess) only in case the SPV has opted for a concessional tax regime. No withholding tax is required in case the SPV has not opted for a concessional tax regime.

Where the lease rental income, received by the REIT, is distributed to non-resident unit holders, the REIT is required to withhold tax at the rates in force, ie, the applicable tax rate in the case of individuals and 40% (plus applicable surcharge and cess) in the case of corporates.

Tax treatment at investor level

Resident investors

The income distributed by the REIT, received by it by way of interest, dividend or lease rent, could be taxed at a maximum rate of the applicable tax rate. The tax withheld, as discussed above, should be available as credit.

Any other income distributed by the REIT (viz. capital gains, etc) ought not to be taxable in the hands of the investors.

Tax implications on capital gains on the sale of the units in the REIT listed on a recognised stock exchange in India and on which securities transaction tax (STT) is paid are discussed below:

Holding period	Tax rates (%)*
Up to 36 months	15
More than 36 months	10

* to be increased by applicable surcharge and cess

Non-resident investors[13]

The income distributed by the REIT, received by it by way of interest should be taxed at the rate of 5% (plus applicable surcharge and cess).

The income distributed by the REIT, received by it by way of dividend should be taxed at the rate of 20% (plus applicable surcharge and cess) only in case the SPV has opted for a concessional tax regime. The income distributed by the REIT, received by it by way of dividend, is exempt from tax in case the SPV has not opted for a concessional tax regime.

[11] Tax implications, where securities are listed on stock exchange in India are not considered.
[12] The concessional tax regime refers to the SPV opting for a taxation rate of 22% (plus applicable surcharge and cess) subject to fulfilment of certain conditions.
[13] Availability of treaty benefits, if any, has not been considered.

Lease rent income received by the REIT, distributed to the unit holders, could be taxed at the applicable tax rate, in the case of individuals and at the rate of 40% (plus applicable surcharge and cess), in the case of corporates.

The tax withheld, as discussed above, should be available as credit.

Tax implications on capital gains from the sale of the units in the REIT would be same as discussed above in case of resident.

Sponsor

As regards the sponsor, the swap of shares in an SPV for units in a REIT is a transaction exempt from tax.

However, MAT at the rate of 15% (plus applicable surcharge and cess) for a sponsor being a corporate entity would be applicable at the time of eventual sale of REIT units. A separate computation mechanism is prescribed for calculation of MAT, with respect to the sponsor. MAT provisions would not be applicable in case sponsor has opted for concessional tax regime.

In case units are received in exchange for assets, other than shares in an SPV, such a transaction should be chargeable to tax as follows:

Holding period	Tax rates (%)*
Up to 24 months	Applicable tax rates
More than 24 months	20

* to be increased by applicable surcharge and cess

Transfer pricing (TP)

The Indian Transfer Pricing Code provides that the price of any international and specified domestic transaction between associated enterprises is to be computed with regard to the “arm’s length” principle. However, the transfer pricing legislation is not applicable when the computation of the “arm’s length” price has the effect of reducing income chargeable to tax or increasing losses in India. This is aligned with the legislative intent to protect the Indian tax base.

Secondary adjustment

To address the collateral consequences arising from a primary TP adjustment, a concept of a secondary TP adjustment has been made applicable for primary TP adjustments after 1 April 2016. The secondary TP adjustment is required where a primary adjustment to the transfer price occurs in one of the following circumstances:

- voluntarily made by the taxpayer in the tax return; or
- made by the tax officer and accepted by the taxpayer; or
- determined by an Advance Pricing Agreement (APA) entered into by the taxpayer; or
- made as per the safe harbour rules; or
- resulted from a Mutual Agreement Procedure (MAP) resolution.

The primary adjustment, if not repatriated to India within the prescribed time, shall be deemed to be an advance made by the Indian taxpayer to such associated enterprise. Also, interest on such advance shall be computed in the hands of the taxpayer in prescribed manner.

Interest deductibility

The law with effect from 1 April 2018 limits the amount of interest deduction in case an Indian company or permanent establishment of a foreign company being a borrower pays interest exceeding 10 million INR in respect of any debt issued in either of following manners:

- directly from the related party of such borrower; or
- indirectly through a lender which is not a related party but a related party either provides an implicit or explicit guarantee to such lender or deposits a corresponding and matching amount of funds with the lender as security for such loan.

In case any of the above conditions are satisfied, then the deduction of excess interest would not be allowed. Excess interest shall be the lower of following:

- total interest paid or payable in excess of thirty percent of earnings before interest, taxes, depreciation and amortisation (EBITDA) of the borrower in the relevant year; or
- interest paid or payable to related party for that year.

The excess interest shall be allowed to be carried forward for subsequent eight years.

Specified business

In case of the assessee carrying on specified business (viz. slum redevelopment, affordable housing, warehousing facility for storage of agricultural produce, hotel of certain category, SEZ development, operation and maintenance, etc) the capital cost of depreciable assets would be allowed as 100% deduction in first year. Further, the losses arising from specified business could be carried forward for any period but could be set-off against profits of the specified business only.

Loss carryforward

Losses from letting out of one property can be used to offset rental income from other properties in the same year, thereafter against other types of income, such as business, interest, capital gains, etc, in the same year. However, set off of current year loss from house property against other heads of income is restricted to 2 INR lacs. The unabsorbed losses of one year can be carried forward for the subsequent eight years and used to offset income from house property in those years.

Short-term capital loss on the transfer of one property can be used to offset gain from the transfer of another property or any other capital assets within the same year. However, long-term capital loss on transfer of one property can be used to offset only long-term capital gain on the transfer of another property or any other capital assets within the same year.

Unabsorbed short-term capital losses can be carried forward for a subsequent eight years and be used to offset capital gain in those years. However, unabsorbed long-term capital losses can be carried forward for a subsequent eight years and be used to offset only long-term capital gain on the transfer of another property or any other capital assets.

There are no time limits for carrying forward the unabsorbed depreciation. Where there is any change in ownership or control of closely held companies beyond 49%, the carry-forward of losses (except unabsorbed depreciation) could lapse.

However, to be eligible to carry forward losses, it is important to file annual income-tax returns on or before the prescribed due dates.

General anti-avoidance rule (GAAR)

The Act provides for the GAAR which may be invoked by the Indian income-tax authorities in case arrangements are found to be impermissible avoidance arrangements.

A transaction can be declared as an impermissible avoidance arrangement, if the main purpose or one of the main purposes of the arrangement is to obtain a tax benefit and it:

- creates rights or obligations which are ordinarily not created between parties dealing at “arm's length”;
- results in directly/indirectly misuse or abuse of the Act;
- lacks commercial substance or is deemed to lack commercial substance in whole or in part; or
- is entered into or carried out in a manner, which is not ordinarily employed for bona fide business purposes.

In such cases, the tax authorities are empowered to reallocate the income from such arrangement, or recharacterise or disregard the arrangement. Some of the illustrative powers are:

- disregarding or combining or recharacterising any step of the arrangement or party to the arrangement;
- ignoring the arrangement for the purpose of taxation law;
- relocating place of residence of a party, or location of a transaction or situs of an asset to a place other than provided in the arrangement;
- looking through the arrangement by disregarding any corporate structure; or
- recharacterising equity into debt, capital into revenue, etc.

The guidelines for application of the provisions of GAAR is also prescribed in this regard.

Further, the onus to prove that the main purpose of an arrangement was to obtain any tax benefit is on the income-tax authorities. The taxpayer can approach the Authority of Advance Rulings for a ruling to determine whether an arrangement can be regarded as impermissible avoidance arrangement. Also, GAAR has come into force from 1 April 2017.

Double taxation avoidance agreements (DTAAs)

India has comprehensive DTAAs with over 90 countries. DTAA provisions prevail over Indian domestic law if the provisions are more beneficial to the taxpayer. However, a taxpayer in order to claim the benefit under such DTAAs, should obtain a Tax Residency Certificate (TRC) (containing prescribed particulars) duly verified by the concerned authority of the country of residence of the taxpayer. Further, prescribed Form needs to be provided in case the TRC does not contain all/any of the prescribed particulars.

India is one of signatory to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI). At the time of signature, India submitted a list of 93 tax treaties entered into by India and other jurisdictions that India would like to designate as Covered Tax Agreements (CTAs), ie, tax treaties to be amended through the MLI. Accordingly, on ratification of the tax treaties by the respective jurisdictions with which the India has tax treaty, the existing tax treaty is required to be read in context of the MLI.

MLI entered into force for India on 1 October 2019. Out of the 93 countries above, 28 countries have not signed MLI and four countries have not notified the tax treaty with India. Out of the balance 61 countries, MLI entered into effect on 1 April 2020 for certain countries (including only for withholding tax purposes for certain countries).

Indirect taxes

Indirect taxes in India include customs duty on import of goods into India and goods and services tax (GST) on supply of goods and services in India.

GST, being India's biggest tax reform completed its three years of implementation in July 2020. Over the period of three years, there were highs and lows in revenue collection, rationalisations in rates of taxes on various goods/services, challenges in undertaking compliances, speedier disbursement of refund claims, introduction of a tax composition scheme for real estate developers, changes in reporting formats, etc were witnessed.

The Government has shown its clear intention to automate the GST system for reducing tax evasion and improving data gathering from different sources. The same can be evidenced by linking of e-way bill system with GST filing interface, proposed introduction of e-invoicing system and new return formats to revamp the return filing process.

We have provided below an overview of how indirect taxes apply to the real estate sector.

Goods and services tax (GST)

Residential real estate

To boost the residential real estate segment, a new rate scheme was introduced by the Government effective from 1 April 2019 which was made applicable to all the projects commencing on or after 1 April 2019 and to ongoing projects as on 31 March 2019. This was a major step taken by the Government under the GST regime to ease the pressure on this sector and was in line with the government initiative of "Housing for All by 2022" where a concessional rate of 1% GST was introduced for "affordable housing".

The Government has aligned the GST law with the Real Estate Act by introducing and matching the concepts of "promoter", "project", "apartment", "carpet area", etc from the Real Estate Act. This should clarify certain interpretational aspects under the GST law which existed prior to the alignment with the Real Estate Act.

The GST rates were reduced from 8% to 1% for affordable housing projects and 12% to 5% for other projects under the new tax rate scheme. The benefit of lower GST rates was made subject to fulfilment of several conditions, the key ones being – a) GST was to be paid in cash without availing any input tax credit (ITC), and b) 80% of the procurement of goods and services should be from registered dealers. The developers were also provided with a one-time option to either transition to new rate scheme or remain in the old rate scheme for ongoing projects.

Prior to 1 April 2019, the concessional rate of 8% was available for affordable housing projects undertaken for the economically weaker sections of the society under various Government schemes – typically for apartments having a carpet area of up to 60 square metres. From 1 April 2019, this concessional rate of 1% was available to all affordable housing apartments with carpet area of 60 square metres (for metro cities) and 90 square metres (for non-metro cities) with value cap of 4.5 million INR.

Another crucial step taken by the Government was clarifying various aspects relating to taxability of development rights (TDR), floor space index (FSI), premium for long term lease, which had been contentious matters. Effective 1 April 2019, the supply of TDR, FSI, long term lease (premium) of land by a landowner to a developer for residential projects was exempted with the condition that under construction flats are sold on GST paid basis. Thus, the liability to pay GST on TDR, etc on such residential projects would arise only to the extent of unsold inventory as on the date of completion of the project. However, for commercial projects, GST is required to be discharged on full value of TDR, etc. The Government has not addressed industry concerns on the value component of land which is available for deduction (currently 1/3) on the total value of sale. Such concerns stem from the fact the flat land deduction component was not reflective of market value as it varies significantly across markets.

The changes with effect 1 April 2019 received mixed inputs from industry players. While the reduction of the tax rate and alignment with the Real Estate Act was welcomed, the restriction on ITC availment was questioned as it would result in increased costs for industry players. Certain relaxations have been provided under the Real Estate Act and the GST regulations in light of global COVID-19 pandemic.

Commercial real estate

While residential real estate was subjected to various rate changes, the GST regime on commercial real estate was left unaltered for both sale and lease transactions. Sale of under-construction commercial real estate attracts GST at 12% (after the 1/3 deduction for land) while rentals attract GST at 18%. Sale of completed real estates is GST free.

It should be noted that GST law restricts ITC availment on procurements of goods and services used for creating an immovable property; thus, ITC on construction activities, if the statute is read literally, is barred where the constructed property is intended to be leased out (but not sold). A recent ruling[14] by the Orissa High Court has however allowed ITC on purchase of goods and services for construction of a mall for payment of GST on rentals by reading down the GST statute to apply only to a situation where the property is retained for one's own use/ purpose, and not when property is let out on payment of GST. Also, the High Court has opined that allowing credit when the property under construction is for sale and disallowing it when it is leased out may not be an appropriately legal outcome. Post this ruling, similar petitions have been filed before various other High Courts in India. Currently, an appeal filed by the revenue authorities against the decision of the Orissa High Court is pending before the Supreme Court. The final decision by the Supreme Court will have an impact on the real estate sector and similarly placed industries such as hotels, warehousing, etc. Accordingly, the industry players engaged in leasing of commercial spaces may need to review their financial and tax models to accommodate the outcome of this ruling.

Other taxes/levies

Stamp duty

Stamp duty is a state levy and is payable on certain types of instruments, ie, documents. In respect of immovable property, the stamp duty is generally payable on the basis of the market value of the property at different rates, depending upon the nature of the transaction, ie, sale, lease, release, etc. Corporate restructuring including immovable property may also attract stamp duty. The State Government fixes market value of all properties in an area at the beginning of each calendar year and the market value so fixed is required to be accepted as the basis for calculating stamp duty in respect of an instrument, ie, document by virtue of which property is dealt with. Different rates of stamp duty are applicable in different states. The rates generally range between 5% and 15%. Corporate restructuring also requires stamp duty. Further, property transactions are also subject to registration fees.

Municipal tax

Municipal corporations or other local bodies are entitled to recover property taxes from buildings constructed in cities and towns. The property taxes are levied on “rateable values”, fixed on the basis of market value of the property or the rental returns, which the property owners derive from the property.

[14] TS-350-HC-2019(ORI)-NT

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All information used in this content, unless otherwise stated, is up to date as of 24 August 2020.

Real Estate Tax Summary

General

Under the current land regulations, the option for a foreign citizen and/or entity to own land (and buildings, as the case may be) in Indonesia is quite limited and depending on the selected line of business (ie, that is open to direct foreign investment). A foreign investor may acquire limited land titles in Indonesia by forming an Indonesian direct foreign investment company or acquiring an existing Indonesian limited liability company.

Rental income

Rental income from real estate property is subject to final income tax rate of 10% from the gross rental fee. The final tax on rental of land/buildings is withheld by third parties (ie, tenants) and constitutes the final settlement of the income tax for that particular income. Consequently, any corresponding expenses (including depreciation of the relevant buildings and interest expense) will be non-deductible for tax purposes.

Transfer of land and building

A transfer of rights to land and building will give rise to income tax on the deemed gain on the transfer/sale to be charged to the transferor (seller). The tax is set at 2.5% of the gross transfer value (tax base). For transfers of simple houses and simple apartments conducted by taxpayers engaged in a property development business, the tax rate is 1%.

On the transferee side, an acquisition of land and building rights will give rise to 5% duty (*Bea Perolehan Hak atas Tanah dan Bangunan*, or BPHTB). The 5% duty is imposed on the higher of the transaction value or the sale value of the tax object (*Nilai Jual Objek Pajak*, or NJOP).

Withholding tax on sales of luxury goods

A corporate taxpayer who sells luxury goods must withhold/collect (Article 22) income tax at 1% (this has been reduced from the previous 5%) of the selling price excluding VAT and luxury sales tax. The luxury goods include landed houses, apartments, condominiums, and similar types of building exceeding certain stipulated threshold of selling price or building area.

Value-added tax (VAT)

Real estate transactions are also subject to VAT at the rate of 10%. For these purposes, real estate transactions include rental and sales of real estate properties. Charges for common services for office buildings and the like are also subject to VAT at 10%

Luxury sales tax (LST)

LST is levied at 20% on apartments, condominiums, luxury houses and town houses of the type of strata title and/or non-strata tittle (disregarding the type of title), and those of similar type with a sale price of 30 billion Indonesian rupiahs (IDR) or more.

Real Estate Investments

Legal aspects

Investing in real estate

Indonesian law and regulations do not specifically use the term “real estate”. The reference to “real estate” in the Indonesia’s Standard Business Classification Code (KBLI) includes land and any buildings or structures on it. Generally, buildings or structures on land are also owned by the landowner. However, Indonesian land law acknowledges the horizontal land separation principle (*asas pemisahan horizontal*), where buildings or structures on a land are not part of the land, ie, the rights over the land do not automatically cover ownership of the buildings or structures on it.

Generally speaking, an interest in real estate can be held by foreigners through land ownership (ie, based on a particular land title) or land lease schemes. Under the current land regulations, the option for a foreign entity to own land (and buildings, as the case may be) in Indonesia is quite limited (ie, through HGB, HGU, HP, and *Hak Sewa* – as further explained below). Depending on the selected line of business (ie, that is open to direct foreign investment), a foreign investor may acquire limited land titles in Indonesia by forming an Indonesian direct foreign investment company (known as “PT PMA”) or acquiring an existing Indonesian limited liability company (status of which will then be converted to PT PMA upon acquisition).

Real estate business activities – direct foreign investment

In terms of real estate business, Presidential Regulation No 44 of 2016 on the List of Business Sectors Closed and Open for Investment with Conditions (“Negative List”) provides that real estate brokerage is closed for foreign investors while real estate development is not regulated under the Negative List and thus arguably should be open for foreign investors.

Having said that and given the current policy of foreign investment in Indonesia, the investment should be categorised as a large-scale and significant real estate development.

In accordance to Law No 25 of 2007 on Capital Investment, foreign investment may only be made by establishing a limited liability company, unless determined otherwise by law. The requirement applies in particular for income generating activities. Such limited liability company established by a foreign party, ie, companies and individual either fully owned or jointly with Indonesian parties is commonly referred to as foreign investment company (PT PMA). This PT PMA will need to be registered and obtain licenses from the Online Single Submission (OSS) administered by the Investment Coordinating Board (BKPM). PT PMA will need to register for a Business Identification Number (*Nomor Induk Berusaha*, or NIB) and obtain a Business License (*Izin Usaha*). The Business License will only enter into force once commitments such as the Location Permit and Environment Permit have been completed. If a foreign party wants to establish a PT PMA, based on the current investment policy by BKPM, there will be a minimum investment of 10 billion IDR, or equal to 714,000 USD. This investment can either be fully sourced from capital or combination between capital and loan. Should the investment be made through a loan, the minimum capital should be 2.5 billion IDR, or equal to approximately 178,500 USD.

Types of land titles in Indonesia

Generally, there are six types of land titles recognised in Indonesia:

- Right of Ownership (*Hak Milik*, or HM)
- Right to Build (*Hak Guna Bangunan*, or HGB)
- Right to Use (*Hak Pakai*, or HP)
- Right to Cultivate (*Hak Guna Usaha*, or HGU)
- Right to Manage (*Hak Pengelolaan*, or HPL)
- Right to Lease (*Hak Sewa*)

Hak Milik (HM)

HM is the strongest and fullest hereditary right which may be held on land. HM does not have any time limit. However, all the rights to land in Indonesia (including HM) have a social function, meaning that the usage of the land has to comply with the condition and nature of the right, thereby benefiting the owner, the community and the country.

HM can only be owned by Indonesian citizens (individuals) and some corporate entities determined by the government (eg, social and religious institutions). Other Indonesian corporate entities and foreign citizens may not own land with HM.

HM may be transferred to other parties either by sale/purchase, exchange, donation, inheritance and other acts meant for the transfer of HM. HM can also be pledged as collateral for debt by encumbering it with a mortgage (*Hak Tanggungan*) or encumbrance right under Law No 4 of 1996 on Mortgages ("Mortgage Law").

Right to build (HGB)

HGB is basically a right granted by the government to establish and construct (buildings) on land for a period of, theoretically, at the most 30 years, which may be extended for another 20 years. Nowadays, we normally see HGB certificates, especially in Jakarta, with periods of 20 years. After the term of extension expires, an HGB title may theoretically be renewed for another 30 years.

HGB may be granted to:

(i) Indonesian citizens, and

(ii) Indonesian corporate entities established under Indonesian law and domiciled in Indonesia, including PT PMA.

HGB may be acquired by:

- transferring the (existing) HGB from the holder to the transferor, by sale/purchase, exchange or donation; or
- creating or granting the HGB title on top of land already granted HM or HPL, or on state land (*tanah negara*).

HGB may also be pledged as collateral for debts by encumbering it with a mortgage.

Right to use (HP)

Law No 5 of 1960 on Agrarian Affairs ("Agrarian Law") defines HP as the right to use and/or collect the products of land directly administered by the government. The types of land on which HP title can be granted are state land, and HM and HPL land. This means that HP title can be created on top of these land titles (HM and HPL).

HP title is granted for a maximum period of 25 years and can be extended for a maximum of 20 years. Afterwards, the term can be renewed for another 25 years. HP on HM land is granted for a maximum of 25 years and cannot be extended. Theoretically, HP can also be granted for an unlimited time, to be used as government offices, international organisation offices or foreign embassies.

HP may be owned by:

(i) Indonesian citizens;

(ii) foreigners residing in Indonesia;

(iii) corporate bodies established according to the Indonesian law and domiciled in Indonesia (including PT PMA);

(iv) foreign corporate bodies with a representative in Indonesia;

(v) departments, non-department government bodies and regional governments;

(vi) foreign country representatives and international organisation representatives; and

(vii) religious and social institutions.

Under the relevant law, land with HP title may also be pledged as collateral.

Right to cultivate (HGU)

HGU is the right to cultivate land which is administered by the government. This title is normally granted to land for cultivation/plantation businesses. The period of HGU title is 35 years and may be extended for another 25 years, with renewal for another 35 years at the most. The minimum size of land for HGU is five hectares, and the maximum is 25 hectares (for individuals). For corporate bodies, these sizes will be determined by the Land Office.

HGU may only be granted to:

(i) Indonesian citizens; and

(ii) Indonesia corporate entities based in Indonesia, including PT PMA.

Right to manage (HPL)

The title is only granted to state-owned companies and government agencies with, normally, an unlimited term. The land itself normally comes from the land administered by the government and is allocated for government agencies. Theoretically, other land titles, ie, HGB and HP, can be granted on top of HPL land.

Right to lease (*Hak Sewa*)

Article 16 of the Agrarian Law lists *Hak Sewa*, or "right to lease", as one of the "titles" for land. Article 44 of the Agrarian Law further provides that *Hak Sewa* is a land title that gives its holder the right to construct a building on another person's land, upon payment of rent.

While HP is a primary land title as it is granted by the government and constructed on state land, *Hak Sewa* is a secondary or derivative title granted by a holder of a land title. As *Hak Sewa* is a derivative title, Hak Sewa in practice is rarely used.

Hak Sewa is not a registered land title with the Indonesian Land Office. It is generally a contractual right over the existing title. This could be used for example for build, operate and transfer schemes (which might be the case in respect of retail business).The only protection given to leases is under Article 1576.1 of the Indonesian Civil Code which loosely provides that the "*Selling of a leased object does not terminate the lease on the object unless it has been agreed so upon the entry into the lease agreement*".

Land registration system in Indonesia

Indonesia's land registration was initially based on a system commonly known as "registration of deeds". After the Agrarian Law was enacted in 1960, Indonesia adopted a system commonly known as "registration of title" because (i) land registrations are recorded in a land registration book at the relevant Land Office, and (ii) land title certificates are issued to serve as a strong evidence of ownership to land. However, the Land Office does not provide a guarantee on the status of the land being registered as the land certificates are not construed as absolute evidence of ownership, ie, if other parties can prove in a court of law ownership over a plot of land title that has been issued a land certificate, then such land certificate can be cancelled.

The Indonesian law concept provides that a land certificate is a proof of rights which serves as strong evidence of the physical and juridical data stated therein, as long as the physical and juridical data are in accordance with the data stated in the related measurement letter and land registration book.

Land title registration is managed by the regional Land Office within the jurisdiction where the land/premise is located.

Brief overview of land acquisition

The process of land acquisition in Indonesia is relatively complex and time-consuming. Generally, the procedure of acquiring land in Indonesia under the relevant land regulation is as follows:

Obtaining a Location Permit (*Izin Lokasi*)

Based on Minister of Agrarian Affairs/Head of National Land Agency Decree No 2 of 1999 on Location Permits (Decree No 2/1999), a company which has obtained investment approval must obtain a Location Permit to acquire land for its business activities. In practice, this requirement will also apply for every non-PT PMA that will acquire land for its business activities.

A company must apply for a Location Permit from a local government (Municipality/Regency Government/*Bupati*). Before granting the Location Permit, the *Bupati* will consider, among other things, the recommendation of the *Camat* (District Head) and the *Lurah* (Head of Village), and the zoning of the area.

The Location Permit allows its holder to acquire land covered by the approval in accordance with a regional development plan and to apply for the transfer of the rights over that land. A holder of a Location Permit must acquire the land subject to those rights within one to three years depending on the size of the land (which can be extended to one year subject to the fulfilment of certain conditions, and if the holder of the Location Permit has

acquired 50% of the land granted under the Location Permit); otherwise, the holder may lose the right to acquire the land covered by the Location Permit.

However, exemptions from the requirement to obtain a Location Permit apply in the following events:

- The land derives from retribution in kind (*inbreng*) from a shareholder of the company.
- The land is already controlled by another company, and it is being acquired for the purpose of continuing the investment plan of the other company, provided that approval from the relevant authority has been obtained.
- The land is located in an industrial complex/zone.
- The land is from a development authority of a certain region, which is in accordance with the regional development plan.
- The land is required for the expansion of an ongoing business, for which the expansion has obtained the required approval from the relevant authorities.
- The land is less than 25 hectares (for the agriculture business sector), and not more than 1 hectare (for non-agriculture industries).
- The land is already owned by the company, and the purpose of the land is in accordance with the zoning plan determined by the government.

The procedure to grant the Location Permit is essentially based on the review of the land acquisition process and technical land management data, consisting of the physical examination of the land, and the use and the conditions of the land.

As a general rule, a Location Permit is considered a license and therefore is not transferable. However, if a company that has obtained a Location Permit intends to transfer the Location Permit to another company, the transferee will need to submit an application to the regional government covering the same area of the Location Permit held by the transferor. At the same time, the transferor also submits an application to revoke the Location Permit which he currently holds and requests that a new Location Permit be issued to the transferee for the same location that of the Location Permit held by the transferor. Accordingly, the regional government will issue a new Location Permit under the name of the transferee.

Since a Location Permit is issued by the local government (Municipality/Regency Government/*Bupati*), there may be local regulations that need to be considered.

With the current licensing system through OSS, a company's Business License which was issued by the OSS will not be deemed effective until fulfilling some commitments which includes obtaining the Location Permit.

Transaction documents in real estate transactions

Generally, a buyer will be the one who prepares the documentation related to the acquisition of real estate. To effect a title transfer due to sale and purchase, exchange, grant, in-kind contribution, the parties to the transaction must sign a title transfer deed in a form which is already prepared by the government and the execution of such deed must be conducted before a Land Deed Officer (PPAT) who is licensed to practice in the area where the land is located.

Usually the following documents are involved in real estate transactions:

- Conditional Sale and Purchase Agreement: This document is suggested if the title transfer is subject to certain conditions. For example, a title transfer over a certain type of land title, eg, HGU, is subject to government approval. This document also contains the details of commercial terms of the transaction, eg, deposit (if any).
- Deed of Sale and Purchase of Land (*Akta Jual Beli Hak Atas Tanah*): This is the required document for the transfer of ownership over land. It is prepared by a PPAT and signed by the buyer and the seller before the PPAT.

Costs usually shouldered by the parties in real estate transactions

The buyer usually pays for:

- buyer's agent's fees (if any);
- legal service fees;
- due diligence fees;
- PPAT service fees;
- land registration fees; and

- land acquisition duty.

The seller usually pays for:

- listing agent's fees (if any);
- legal service fees; and
- income tax on the sale of the real estate.

Granting of a land title

Once all requirements to obtain a land title (eg, HP, HGB or HGU) have been fulfilled, the relevant Land Office will issue a Decision Letter on the Granting of a new land title. After the granting of the new land title, the new land title holder will need to register the land, and the land title certificate will be issued by the regional Land Office.

The issuance of a land title certificate will occur after the company (i) pays the administrative fees in relation to the issuance of a land title (which can be substantial depending on the circumstances) and the land acquisition duty (*Bea Perolehan Tanah dan Bangunan*) at a rate of 5% of the estimated value of the land (determined by the government).

Acquisition of a real estate developer company

Acquisition of a real estate developer company will need to take into account provisions under the Investment Law (eg, a local PT will need to convert its status to become a PT PMA once acquired by a foreign entity) and Law No 40 of 2007 on Limited Liability Companies ("Company Law").

An acquisition resulting in the change in control of a company (whether by a transfer of shares or by way of dilution) needs to follow a strict process under Articles 125 (as applicable) and 127 of the Company Law, requiring acquisition plans and a 30-day creditor and employee notification procedure prior to the "calling" of the General Meeting of Shareholders (GMS) authorising the transfer or issue of shares, etc (notices for GMS require a minimum of 14 clear days). A transfer of a 49% interest to a shareholder that holds 51% is not considered as a transfer of control.

If the acquisition is shareholder-driven rather than by management of the target company, and the acquirer does not need to follow the more complex process set out in Article 125 of the Company Law (ie, preparation of an acquisition plan), there, however, remains a 30-day employee/creditor notification procedure.

Documents required include, among other things:

- an acquisition plan for the target company and purchasing entities, including draft acquisition proposal by directors and directors' resolutions, approved acquisition plan by commissioners (and commissioners' resolutions);
- notices to creditors and employees, a notice calling a GMS, newspaper announcements (including an abridged acquisition plan); and
- shareholders resolutions (amendments to articles, etc), and transfer deed.

Permit and environmental issues

Government authority relating to land development

In general, land development is controlled and monitored by the provincial and sub-provincial governments as well as the Land Office. The authorised party for the environment is the Ministry of Environmental Affairs. However, each province has received delegation to regulate issues and matters related to the land development and environment.

What environmental laws affect the use and occupation of real estate?

The environmental laws must be taken into account when the use and occupation of real estate has an impact on environment. Environmental license/approval/documents to manage environmental impact is required before, during and after the commencement of the real estate project. Please also note that an environment analysis to the business activity will need to be performed to obtain an Environment Permit which becomes the commitment for the effectiveness of a company's Business License.

Main permits or licenses required for building or occupying real estate

A building construction permit is required for the construction or renovation of real estate properties.

A building use permit/building occupational permit is required to be obtained before occupying a building (depending on the applicable regional regulations).

The explanations above consider matters from a general point of view. Local requirements/licenses may be applicable depending on the relevant regional regulations.

Tax aspects

Rental income

Rental income on property owned either by a corporation or an individual is subject to final income tax at the rate of 10% from the gross rental fees (excluding VAT). This is withheld by a company tenant, but for individual and foreign tenants, the landlord is obliged to pay the 10% final tax due on the rental income through a self-assessment mechanism. This 10% tax constitutes the final settlement of the income tax for that particular income.

Gross rental value is the total amount paid or payable by the tenant in whatever name or form with respect to land and/or buildings rented. The gross rental value includes repair costs, maintenance expenses, security expenses and service charges, regardless of whether these exist in a separate agreement or are included in the rental agreement. As the rental income is subject to final tax, all expenses related to the property rental business are non-deductible. Other income (after allowable deductions) of a real estate company, ie, excluding land and building income, will be subject to the normal corporate income tax (CIT).

Under recent tax law changes[1], the CIT rate will be gradually reduced from the current rate of 25% to 22% for the fiscal year 2020/2021 and to 20% starting with the fiscal year 2022.

Meanwhile the CIT rate for publicly listed companies will be reduced by an additional 3% (ie, the CIT rate will become 19% for the fiscal year 2020/2021 and 17% starting with the fiscal year 2022) that satisfy all of the following conditions:

1. Minimum 40% of required listed shares must be owned by a minimum of 300 shareholders.
2. Each of those shareholders may only own less than 5% of the entire issued and fully paid-up shares.
3. The provisions as intended above must be met for at least 183 calendar days within one fiscal year.
4. The fulfilment of these requirements is to be confirmed by submitting a report to the Directorate General of Taxes (DGT).

Transfer of land and building

A transfer of rights to land and building will give rise to income tax on the deemed gain on the transfer/sale to be charged to the transferor (seller). The tax is set at 2.5% of the gross transfer value (tax base). However, for transfers of simple houses and simple apartments conducted by taxpayers engaged in a property development business, the tax rate is 1%. Furthermore, the income from transfers of rights to land and building involving Sale and Purchase Binding Agreement on Land and Building Rights (*Perjanjian Pengikatan Jual Beli*, or PPJB) are also included in the final tax object. This tax must be paid by the time the rights to the land and building are transferred to the transferee. The tax paid constitutes a final settlement of the income tax for that particular income.

In general, the tax base is the higher of the transaction values stated in the relevant land and building right transfer deed and PPJB based on actual transaction value or amount that should have been received in the case of a related party transaction. However, in a transfer to the government, the tax base is the amount officially stipulated by the government officer in question in the relevant document. In a government-organised auction, the gross transfer value is the value stipulated in the relevant deed of auction.

A notary is prohibited from signing a transfer of rights deed until the income tax has been paid in full.

Duty on the acquisition of land and building rights

A transfer of land and building rights will typically also give rise to BPHTP duty on the acquisition of land and building rights liability for the party receiving or obtaining the rights. BPHTB is a part of regional taxes. Qualifying

[1] The new regulation also sets out some new provisions which regulate how to apply the numerical fulfilment of the requirements mentioned under 1. and 2. above.

land and building rights transfers include sale-purchase and trade-in transactions, grants, inheritances, contributions to a corporation, rights separation, buyer designation in an auction, the execution of a court decision with full legal force, business mergers, consolidations, expansions, and prize deliveries.

BPHTB is based on the Tax Object Acquisition Value (*Nilai Perolehan Objek Pajak*, or NPOP), which in most cases is the higher of the market (transaction) value or the NJOP of the land and building rights concerned. The tax due on a particular event is determined by applying the applicable duty rate of 5% to the relevant NPOP, minus an allowable non-taxable threshold. The non-taxable threshold amount varies by region: the minimum is 60 million IDR, except in the case of an inheritance, for which starts from 300 million IDR. The government may change the non-taxable threshold via a regulation.

BPHTB is typically due on the date that the relevant deed of land and building rights transfer is signed before a notary public. In a business merger, consolidation, or expansion, the duty is due on the date of signing of the merger, consolidation or expansion deed. In an auction, the duty is due on the date of signing of the Auction Deed by the authorised officer.

A notary is prohibited from signing a deed transferring the rights until the BPHTB due is paid.

Depreciation

For tax purposes, permanent buildings are depreciable in 20 years and non-permanent buildings are depreciable in ten years using the straight-line method, considered that non-permanent are temporary buildings which materials are not durable, while land is not depreciable.

Other expenses and income

Taxable business profits are calculated on the basis of normal accounting principles as modified by certain tax adjustments.

Where a final tax applies, expenses relating to rental and/or sales/transfers of property, including interest, depreciation, and other costs, are not deductible for corporate income tax purposes.

Withholding tax on sales of luxury goods

A corporate taxpayer who sells the following luxury goods must withhold/collect (Article 22) income tax at 1% (this has been reduced from the previous 5%) of the selling price excluding VAT and LST:

- landed houses priced at more than 30 billion IDR or building area of more than 400 square metres;
- apartments, condominiums, and similar types of building selling for more than 30 billion IDR or having building area of more than 150 square metres.

Income tax collected is creditable for the purchasers of goods.

Tax loss carryforward balance and statutory of limitation for issuing a tax assessment

Tax losses may be carried forward for a maximum of five years.

A carryback of the tax losses is not permitted. Where a final tax applies, tax losses cannot be carried forward. A company is engaged in the property business (rental or sales of land and buildings) can no longer carry forward its tax loss.

Under the current Tax Administration Law, the Directorate General of Taxation (DGT) can issue an underpaid tax assessment letter for the years 2008 and onwards within five years after the incurrence of a tax liability, the end of a tax period (month), or the end of (part of) a tax year.

Real estate investment fund

The income that is received or obtained from the transfer of real estate assets to a special purpose company (SPC) or Collective Investment Contracts in the form of a real estate investment fund (*Kontrak Investasi Kolektif - Dana Investasi Real Estate*, or KIK-DIRE) is subject to a 0.5% final tax on the gross value of the assets transferred. If the transfer is made to a related party, the gross value of the assets transferred is the amount that should have been received or obtained on the transfer. If the transfer is made to a third party, the gross value of the assets transferred is the amount that is actually received or obtained on the transfer.

The procedures for this final tax payment and reporting, which is similar to the general procedures in the event of land and building transfer. Further KIK-DIRE is considered to be a low-risk VATable entrepreneur, which is eligible to request for preliminary VAT refund.

Value-added tax (VAT)

VAT applies to real estate transactions at a rate of 10%. For these purposes, real estate transactions include rental and sales of real estate properties. Charges for common services for office buildings and the like are subject to VAT at 10% of the service charges.

VAT on the sale price of land and buildings, as part of a real estate or industrial estate price, is levied at the rate of 10% of the invoice value.

VAT on any self-construction work on the following buildings is levied at 2% of total costs incurred or paid, exclusive of the acquisition price of land:

- residential house or place of business, and
- building space which is equal to or bigger than 200 square metres.

Excluded from the VAT is the delivery of a basic house, very basic house, basic apartment, rented cottage, student dormitory, and other housing as defined by the Minister of Finance upon hearing the consideration of the Minister of Settlement and Regional Infrastructures (eg, religious and social buildings). In addition to the exemption, services provided by the building contractors for the construction of places which are merely intended for worship purposes are also excluded from VAT.

Luxury sales tax (LST)

LST is levied at 20% on apartments, condominiums, luxury house and town houses of the type of strata title and/or non-strata tittle (disregarding the type of title), and those of similar type with a sale price of 30 billion IDR or more.

Land and building tax

Land and building tax (*Pajak Bumi dan Bangunan*, or PBB) is a type of property tax chargeable on all land and/or buildings, unless exempted. PBB is a part of regional taxes which are governed under Regional Taxes and Retribution Law in which each regional government has to issue a regulation to regulate PBB in its territory.

PBB is payable annually following a Tax Due Notification Letter (*Surat Pemberitahuan Pajak Terhutang*, or SPPT) issued by the regional government.

An individual or an organisation that owns a right to a piece of land, and/or takes benefits there from, and/or owns, controls, and/or takes benefits from a building can by law be regarded as the PBB taxpayer for that piece of land and/or building.

The PBB rate is maximum 0.3% and the tax due is calculated by applying the tax rate on the sale value of the tax object (*Nilai Jual Objek Pajak*, or NJOP) deducted by non-taxable NJOP. The non-taxable NJOP is set at 10 million IDR at the minimum. Any changes are to be made by issuing a regional regulation.

Profit distributions

Profit distributions in the form of dividends are subject to tax as follows:

- For resident shareholders, dividends received from an Indonesian company by a limited liability company incorporated in Indonesia (*Perseroan Terbatas*, or PT), a cooperative, or a state-owned company, are exempt from income tax if the following conditions are met: the dividends are paid out of retained earnings; and for PTs and state-owned companies, the company earning the dividends holds at least 25% of the paid-in capital in the company distributing the dividends.
- If these conditions are not met, the dividends are assessable to the company earning the dividends at the ordinary tax rate together with the company's other income. Upon declaration, dividends are subject to Article 23 income tax withholding at 15%. The amount withheld constitutes a prepayment of the corporate income tax liability for the company earning the dividends. Dividends received by resident individual taxpayers are subject to final income tax at the rate of 10%.
- As for non-resident shareholders, the dividends are subject to withholding tax of 20% (or the applicable reduced treaty rate).

Other matters

The government issued several tax regulations that intended to response and help secure national economic stability during the COVID-19 pandemic. A real estate company with a certain business classification is one of the lists of eligible taxpayers to take advantage of the following tax incentives:

- Article 21: The employee income tax for employees earning an annual regular income not exceeding 200 million IDR will be borne by the government.
- Article 22: Income tax on imports will be exempted.
- Article 25: Reduction of monthly income tax instalment, ie, 30% and 50% reduction are applicable for the tax periods April-June 2020 and July-December 2020 respectively.
- Preliminary VAT refund will be available for eligible taxpayers requesting a refund for a maximum 5 billion IDR.

As at the writing date, the eligible tax incentive periods are applicable until December 2020. It is important to monitor developments on the covered period.

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Real Estate Going Global

Ireland

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

A foreign corporate investor may invest in Irish property directly, or through a local Irish subsidiary company. The selection of the appropriate structure for an Irish property investment should be heavily influenced by a consideration of the tax issues that are likely to be relevant to that investment, such as the rate of tax applying to Irish profits, the tax rules applying in the investor's home country and the investor's plans in relation to the repatriation of profits generated in Ireland.

If it is anticipated that the Irish investment will be in a loss-making position for tax purposes or will only generate small profits in the initial years, there is probably little merit in seeking to defer taxation in the investor's home country. In these circumstances, a branch of a company that is tax resident in the investor's home country may be the most suitable structure.

Where the Irish operation is generating significant taxable profits, the structuring decision is likely to be more complex. The primary aim of the structuring decision in this situation might be to defer home country tax on Irish source profits either permanently or until such time as those profits are repatriated. However, other factors that will inform the structuring decision include the investor's future plans for utilisation of the after-tax profits earned in Ireland, and the potential application of anti-avoidance legislation such as controlled foreign corporation legislation in the investor's home country.

On a related note, Ireland is increasingly being selected as the low-taxed "principal" company in a number of key global corporate structures. These structures provide a robust and sustainable platform to manage a group's international business and also help deliver a tax efficient result. Many of our multinational clients have successfully implemented the structures outlined in this document.

Rental income

The rental income of an Irish tax resident company (or an Irish branch of a non-resident company) is liable to corporation tax at the passive rate, currently 25%. A non-resident company that does not operate through an Irish branch is liable to Irish income tax (as opposed to corporation tax) at the standard rate, currently 20%. The net rental income that is liable to tax is based on net profit as determined under normal accounting principles, with some small differences, particularly with regard to expenditure incurred before the letting of a property, interest expenses, and specific rules in relation to relief for capital expenditure.

A 20% corporation tax surcharge is chargeable on the net distributable rental income of a "close company" if that company does not distribute that relevant income within 18 months of the end of the accounting period in which the income was earned. A "close company" is defined as a company that is tax resident in Ireland and under the control of five or fewer participators (eg, shareholders and holders of certain debt instruments) and their associates, or under the control of any number of participators who are directors. A company that is not tax resident in Ireland is not liable to this surcharge.

Withholding tax on rents

An Irish tax resident lessee/tenant must withhold tax at the standard rate of income tax (currently 20%) from rents paid to a non-resident landlord. Any tax withheld can be offset against the non-resident landlord's ultimate Irish tax liability, and a refund can be obtained of any excess. There is no requirement for the lessee/tenant to withhold tax from rents if the rents are paid to an agent in Ireland, who is acting on behalf of the non-resident landlord.

Capital gains tax

Capital gains tax (CGT) will apply to gains arising on the sale/realisation of any Irish property, and shares which derive their value directly or indirectly from Irish property, irrespective of whether the vendor is tax-resident in Ireland. The capital gain is calculated by deducting the cost of the property (as adjusted to reflect inflationary movements to 31 December 2002, for property acquired before that date) from the net sales proceeds. A deduction may be available for certain costs incurred in enhancing the property, and also for incidental costs associated with the sale of the property. The rate of capital gains tax is currently 33%.

Where an Irish property (or shares in an Irish property company) is disposed of for consideration in excess of 500,000 EUR or 1 million EUR in the case of residential dwellings, the vendor must provide a CGT clearance certificate to the purchaser, which can be obtained from the Irish Tax Authorities. In the absence of such a certificate, the purchaser is obliged to withhold tax of 15% from the gross consideration.

Real Estate Investments

Introduction

The climate for investment in real estate in Ireland has changed significantly in recent years. Following a period of significant expansion of the Irish economy in the 1990's/early 2000's and growth in property values generally, the subsequent period has seen a very significant contraction in the economy and reductions in land and property values, followed by a recovery in recent years. The Irish property market, which would have historically been dominated by domestic investors, is now experiencing significant interest from foreign investors, many of whom have acquired property via the loan sales conducted by the banks in recent years.

In the past, typical lease terms in Ireland were 20 to 25 years, although a practice of shorter lease terms is emerging. Recent legislation has removed landlords' rights to upwards-only rent reviews for all leases granted on or after 28 February 2010.

In the current market, it is not unusual for landlords to grant incentives to new tenants in the form of rent-free periods, contribution towards fit-out costs, break clauses, rent-free parking spaces, etc.

Taxation framework

For many years, Ireland has used the tax system to help attract foreign investment which is critical to the ongoing development of the economy. The main emphasis of the current tax regime for trading companies is on the 12.5% standard corporate tax rate for active business profits rather than on tax incentives or tax holidays. In addition, there have been a number of significant holding company and intellectual property-related developments in recent years including a foreign tax credit pooling system for dividends, increased and refundable research and development (R&D) tax credits, a new onshore intellectual property (IP) tax deduction regime and a participation exemption from capital gains, which make Ireland increasingly attractive for international investors.

Corporation tax

Ireland operates a classical system of company taxation under which tax is payable by shareholders on dividends received with no credit available to shareholders for tax paid at the corporate level.

Tax rates

The tax rates currently applying in Ireland are as follows:

Income	Tax rate (in %)
Trading/"active" income	12.5
Unearned/"passive" income	25
Capital gains	33

To avail of the 12.5% standard corporation tax rate on trading profits, some level of real presence in Ireland is required. Profits of a foreign branch of an Irish resident company will generally be regarded as trading income of the Irish company if they arise from a trade that is at least partly undertaken in Ireland. Under the terms of Ireland's double taxation agreements, any "foreign tax" suffered in another country on the profits of branch trading in that country is generally credited against the Irish tax payable on the profits of the foreign branch. The 12.5% tax rate also applies to dividends paid out of trading profits by a company resident in an EU/tax treaty country.

A 25% corporation tax rate applies to passive income of Irish resident companies. Passive income includes "unearned" income such as interest, royalties, dividends (other than certain foreign dividends which may qualify for the 12.5% trading rate) and rents from property. Income from a trade carried on wholly abroad is also treated as passive income, as are profits from land dealing, mining and petroleum extraction operations.

Tax residency and scope of Irish tax

A company resident in Ireland for tax purposes (an "Irish tax resident") is subject to corporation tax on its worldwide income. A company may be Irish tax resident under either the "incorporation" test or the "management and control" test.

A company incorporated in Ireland is automatically considered to be Irish tax resident, unless it is considered to be resident in another jurisdiction under the terms of a relevant Double Taxation Agreement.

A company would also be considered Irish tax resident if it is centrally managed and controlled in Ireland.
A company will usually be regarded as being centrally managed and controlled in Ireland if directors' meetings are held in Ireland and all major policy decisions effecting the company are taken at those meetings. Such a company would be regarded as Irish resident regardless of its place of incorporation.

A company that is not tax resident in Ireland is liable to Irish corporation tax only on profits arising from a business conducted through an Irish branch. An Irish branch of a company that is not Irish tax resident may be liable to tax in Ireland. The following points are relevant in this regard:

- The taxable profits of a branch are determined in the same way as for resident companies.
- A deduction may be taken for a reasonable proportion of head office expenses which are directly attributable to the activities of the branch.
- No withholding tax (WHT) arises on repatriation of branch profits to the foreign head office.

A non-resident company that does not operate through an Irish branch is liable to Irish income tax (as opposed to corporation tax) at the standard rate, currently 20%, on Irish source income, subject to the provisions of a double taxation agreement.

Tax base

Corporation tax is charged on the taxable profits of a company. "Taxable profits" for this purpose include income (ie, trading income and passive income) and capital gains arising on the disposal of capital assets.

Tax return filing requirements

The Irish tax system incorporates a self-assessment regime under which a company is obliged to determine whether or not it is chargeable to corporation tax and, if so, to file a tax return and make an appropriate tax payment.

When a company first comes within the charge to Irish tax, the company (whether an Irish company or a foreign company through its Irish branch) is required to register for Irish corporation tax (and other taxes such as Pay As You Earn (PAYE)/Pay Related Social Insurance (PRSI) or VAT, if applicable) by filing a Form TR2 with the Irish Tax Authorities.

The Irish Tax Authorities operate an online service (www.ros.ie), an internet based system that allows taxpayers to file tax returns over the internet and view details of their tax balances, returns filed, etc.

In general, a company's tax accounting period will coincide with its financial accounting period. However, a tax accounting period may not exceed a period of 12 months so that if a company prepares accounts for, say, an 18-month period, it will have two tax filings, one in respect of the first 12 months of that period and the other for the remaining 6 months.

The concept of a consolidated tax return (a single return for a group of companies) does not exist in Ireland. Each company is required to file an individual return. However, group relief may be available, enabling losses incurred by one group company to be used to shelter taxable income arising in another group company.

The corporation tax return must be filed within nine months of the company's accounting year-end. Where the return is filed after this date, a late filing surcharge is payable and interest charges will also be applied.

The Irish Tax Authorities may, within four years of the end of the accounting period in which the return was filed, decide to conduct an audit of the tax return and revise a company's tax liability as they consider appropriate. It is important that a full and complete tax return is made, as there is no time limit in cases of fraud or neglect.

Tax payments

Preliminary corporation tax payments must be made during a company's accounting period. "Preliminary tax" is generally payable in two instalments, as follows:

- The first instalment is payable in the sixth month of the accounting period. This instalment must be equal to the lower of either:
  - 50% of the final corporation tax liability for the preceding accounting period; or
  - 45% of the corporation tax liability for the current accounting period.
- The second instalment is payable in the eleventh month of the accounting period, and the amount payable at this time should bring the total preliminary tax paid up to 90% of the total corporation tax liability for the current period.

There are two key exceptions to the general preliminary tax rules above:

- The payment dates above do not apply to companies that have a "short" accounting period of seven months or less. In these cases, a single preliminary tax payment of 90% of the total expected corporation tax liability will be payable one month before the end of the accounting period.
- A "small company" is also only required to make a single preliminary tax payment not later than one month before the end of the accounting period. A small company is defined as a company whose corporation tax liability for the preceding accounting period was less than 200,000 EUR on an annualised basis. A small company has the option of making a preliminary tax payment, equal to the lower of 90% of the total corporation tax liability for the current period, or 100% of the corporation tax liability for the preceding accounting period.

Any balance of corporation tax must be paid on submission of the corporation tax return, ie, within nine months of the end of the accounting period. Interest is charged on the late payment or any underpayment of a company's corporation tax liability as set out above.

Capital gains tax

Capital gains tax (CGT) applies to gains arising on the sale of any form of capital assets including property, stocks and shares, land and buildings, goodwill, some debts, options and any non-euro currency. The standard rate of CGT is currently 33%.

Irish resident companies are liable to corporation tax in respect of "chargeable gains" on worldwide disposals, at an effective rate equal to the standard rate of CGT, currently 33%. Companies that are not resident in Ireland are liable to tax on gains arising on disposal of "specified" assets ie, Irish land/buildings, Irish mineral/exploration rights and unquoted shares which derive the greater part of their value from such assets.

Individuals resident or ordinarily resident in Ireland are liable to capital gains tax on gains from worldwide disposals. Individuals resident or ordinarily resident, but not domiciled, in Ireland are liable on gains arising on the disposal of assets situated in Ireland and on all foreign gains, but only to the extent that those gains are remitted to Ireland. Individuals who are neither resident nor ordinarily resident are only liable to CGT on gains made on the disposal of "specified assets".

Capital gains are calculated by deducting the cost of the asset (as adjusted to reflect inflationary movements to 31 December 2002, for assets acquired before that date) from the sales proceeds, with a deduction also available in respect of enhancement costs, and acquisition/disposal costs. Special rules apply in the case of disposals of land with development value.

Capital losses arising on the disposal of assets may be offset against capital gains arising on other disposals in the same accounting period, or they can be carried forward to be offset against future capital gains. Restrictions apply in the case of gains/losses arising on development land.

The standard rate of CGT is currently 33%.

Holding company and headquarters regime

Ireland is increasingly being used as a regional or global headquarters for many international businesses. The benefits of placing high added value and strategically important business functions in Ireland are further enhanced by a regime that provides for a "participation exemption" from CGT for Irish resident companies on the disposal of a qualifying shareholding (at least 5%) in subsidiaries tax resident in an EU/tax treaty country.

Locating international operations from Ireland also provides access to the EU tax Directives and to Ireland's Double Taxation Agreements. The EU tax Directives reduce WHT on dividends received in Ireland and also facilitate tax efficient mergers and corporate reorganisations.

Capital gains and holding companies - Participation exemption

Companies are chargeable to CGT in respect of gains arising on the disposal of capital assets. The taxable gain (or allowable loss) is arrived at by deducting from the sales proceeds the cost incurred on acquiring the asset (as adjusted to reflect inflationary movements to 31 December 2002, for assets acquired before that date), and any resulting gain is taxable at 33%. It is not possible to offset capital losses against a company's other taxable income, nor is it possible to surrender capital losses to another company within a tax group. However, with some advance planning, it may be possible to get the benefit of capital losses within a tax group.

A "participation exemption" may also be available to exempt gains arising on the disposal of shareholdings in certain companies. A number of conditions need to be satisfied in order for the exemption to apply, including:

- The shareholding must amount to a minimum of 5% of the ordinary share capital and must have been held for a continuous 12-month period.
- The disposal takes place during, or within two years of, the period in which the minimum 5% holding is held.
- The shareholding is held in a company that is resident in an EU Member State (including Ireland) or in a country with which Ireland has a Double Taxation Agreement in force at the time of the disposal, and
- The exemption may only be claimed where the shareholding is in a company whose business consists wholly or mainly of the carrying on of one or more trades. Alternatively, the exemption may also be available if the businesses of the Irish holding company and all companies in which it holds a minimum of 5% of the ordinary share capital, together with all companies in which the company which is being sold holds at least 5% of the ordinary share capital, consist wholly or mainly of the carrying on of one or more trades.

If the holding company does not hold the minimum 5% shareholding but is a member of a group (ie, a parent company and its 51% subsidiaries), the gain arising on the disposal will nonetheless be exempt if the holding requirement can be met by including holdings of other members of the group. As a result, the Irish holding company may be exempt from CGT on a disposal of shares even if it does not directly hold a significant shareholding in the company being disposed of.

The exemption also applies to a disposal of assets related to shares, such as options and convertible debt. However, it does not apply to a sale of either shares or related assets that derive the greater part of their value from Irish property or minerals/exploration rights.

Capital losses arising on the disposal of a shareholding that could have qualified for the CGT participation exemption cannot be offset against other capital gains.

Group treatment of capital gains

Irish tax legislation provides for the deferral of any CGT liability arising on an intra-group transfer of capital assets. In the absence of this provision, a tax liability would arise where a capital asset is transferred from one Irish tax resident company to another Irish tax resident company, both of whom are members of a 75% tax group.

A group for CGT purposes consists of a principal company and its 75% subsidiary companies. A 75% subsidiary is defined by reference to the beneficial ownership of ordinary share capital, owned either directly or indirectly. For the purpose of identifying the beneficial ownership interest in any company, holdings by any company resident in a relevant territory are taken into account.

It is also possible for an Irish tax resident company and an Irish branch of an EEA company in the same group to transfer capital assets without crystallising a capital gains charge, although the asset transferred must remain within the charge to Irish CGT.

Subsequent to an intra-group transfer, a charge to CGT will arise when either:

- the asset is sold outside the group, in which case the tax is calculated by reference to the original cost and acquisition date the asset was first acquired within the group; or
- the company to which the asset was transferred leaves the group while still owning the asset, in which case the gain on the original intra-group transfer crystallises and tax becomes payable by the company leaving the group.

The above provision does not apply where:

- the asset has been held by the company leaving the group for more than ten years;
- the company leaves by reason of it or any other company being wound up (for bona fide commercial reasons); or
- two or more companies, which themselves form a sub-group, leave together and the asset had earlier been transferred between them.

Double taxation agreements

Ireland has signed comprehensive double taxation agreements (DTAs) with 74 countries, of which 73 are currently in effect. The agreement with Ghana is not yet in effect. Negotiations have concluded for new DTAs with Kenya, Kosova, Turkmenistan and Uruguay. Negotiations have concluded on a Protocol to the existing DTAs with Germany, Guernsey, Isle of Man and Mexico. In addition to the negotiation of new treaties, Ireland's existing treaty base will be updated and incorporate the provisions under the Multilateral Convention to Implement Tax Treaty Measures and Prevent Base Erosion and Profit Shifting (MLI).

Irish tax resident companies may avail of Irish treaties. These treaties secure a reduction or, in some cases, a total elimination of WHT on royalties and interest.

A number of Ireland's DTAs contain tax sparing provisions whereby income arising to a resident of a tax treaty country from sources within Ireland will be relieved from tax on repatriation to the home country.

Repatriation of profits from Ireland

Repatriation of profits from an Irish company can be achieved in a number of ways, including by way of dividend payments, interest charges, royalties, or central cost recharges.

Dividends

Ireland operates a dividend withholding tax (WHT) regime. Irish resident companies must deduct WHT at the standard rate of income tax (currently 25%) on payments of dividends or other profit distributions. Many of Ireland's tax treaties provide for reduced or zero withholding on dividends paid to shareholders resident in countries with which Ireland has a Double Taxation Agreement. More importantly, domestic legislation provides for exemptions from dividend WHT for dividends paid to a broad range of shareholders, including:

- Irish resident companies, pension funds and charities;
- residents of EU Member States and countries with which Ireland has a DTA (and whose companies are not under the control of Irish residents); and
- company's resident in non-EU countries, or countries with which Ireland does not have a DTA, that are ultimately controlled by shareholders resident in an EU Member State or a tax treaty country.

There are a number of important administrative obligations that must be satisfied, even where an exemption from dividend WHT may be available.

Interest

Interest WHT at the rate of 20% applies to interest payments made on loans and advances made for a minimum term of 12 months. In general, where a loan is drawn down for trading/business purposes, no WHT will apply where interest on that loan is paid to a company resident in an EU or a tax treaty country, provided that territory imposes a tax on interest receivable. The provisions of double taxation agreements, and the EU Interest and Royalties Directive may provide further relief or exemption from WHT.

Royalties

Royalties in respect of registered patents attract WHT at the standard rate of income tax, currently 20%. A reduced rate of WHT may be available where the recipient is resident in a tax treaty country and the relevant treaty provides for a reduction or elimination of WHT. Patent royalties may also be paid free of WHT where they are paid in the course of a trade or business to residents of an EU Member State (excluding Ireland) or tax treaty territory provided that territory imposes a tax on royalties' receivable.

Other forms of royalty may also attract WHT, including where the royalty constitutes an "annual payment". An annual payment is one that is capable of recurring and which the recipient earns without having to incur any expense. Patent royalty payments to associated companies in the EU may also be exempt from WHT in accordance with the EU Interest and Royalties Directive.

Central cost recharges

These recharges do not generally attract WHT, provided that the underlying costs are not otherwise subject to WHT.

Foreign tax credit system

Foreign taxes borne by an Irish resident company or branch, whether imposed directly or by way of withholding, may be allowed as a credit against tax arising in Ireland on the same/similar income. The calculation of the credit depends on the nature and source of the income, and the credit is limited to the Irish tax payable on the same source of income. A system of onshore pooling applies to foreign dividends from corporate shareholdings of 5% or more, and excess credits can be carried forward indefinitely for offset against corporation tax arising on foreign dividends in later periods. Any excess foreign tax credits that arise in relation to a foreign trading branch may be offset against the Irish tax arising on branch profits in other countries in the year concerned, and any unused credits can be carried forward indefinitely.

Transfer pricing rules

Irish transfer pricing legislation endorses the Organisation for Economic Co-operation and Development (OECD) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations and adopts the “arm’s length” principle.

The rules apply to domestic and international arrangements entered into between associated persons, involving the supply or acquisition of goods, services, money, or intangible assets, and relating to trading activities within the charge to Irish corporation tax at the trading rate of 12.5%.

Under Irish rules, the Irish Tax Authorities have the power to recompute the taxable profit or loss of a taxpayer where income has been understated or where expenditure has been overstated as a result of non-“arm’s length” transfer pricing practices. There is, however, an exemption available for small and medium sized enterprises.

Finance Act 2019 introduced provisions to bring Ireland’s domestic transfer pricing rules in line with the 2017 OECD Guidelines by extending the application of the rules to certain non-trading transactions, enhancing documentation requirements and introducing a “substance over form” provision which provides Irish Revenue with the ability to disregard and re-characterise a transaction in certain circumstances.

Country-by-Country (CbC) reporting

Groups with consolidated annualised group revenue of 750 million EUR or more in a financial year may have a filing requirement of CbC reports. Where Groups have an Irish filing requirement, the first CbC report should be prepared for fiscal years beginning on or after 1 January 2016 and filed with the Irish Revenue within 12 months of the financial year-end. Penalties are in place for failure to provide a CbC report or for providing an incorrect or incomplete report.

All Groups with Irish tax resident constituent entities (including Irish branches of foreign offices) must notify the Irish Revenue of the name and jurisdiction of the reporting entity of the CbC report no later than the last day of the fiscal year to which the CbC report relates. Where there is more than one Irish tax resident constituent entity in the Group, the Group may nominate one such entity to make the notification on behalf of the Irish constituent entities. Where the Group has an obligation to file the Group’s CbC report in Ireland with the Irish Revenue under primary or secondary filing requirements, the filer must notify the Irish Revenue of its intention to file on behalf of the Group.

Value-added tax (VAT)

In common with all EU Member States, Ireland operates a consumption tax known as value-added tax (VAT). VAT is charged on the supply of most goods and services. Businesses that carry on activities that are chargeable to VAT are required to register with the Irish Tax Authorities (certain registration thresholds apply) and account for VAT at the appropriate rate in respect of revenues derived from the supply of goods and services. In practice, VAT is not a cost for most businesses as it may be passed on to customers. Furthermore, “accountable persons” (ie, persons who charge VAT on the supplies of their goods and/or services) can offset the VAT incurred on the purchase of goods and services (with certain exceptions) against the VAT charged on their sales. As a result, there is generally no VAT cost to a business whose activities are fully VAT-able. For this reason, VAT is generally described as a consumption tax since the ultimate cost rests with non-business users or business users engaged in VAT-exempt activities.

Exempt businesses (such as banking and insurance) are typically not required to account for VAT on such supplies of services, and consequently are unable to recover any VAT incurred on related purchases of goods and services (subject to certain exceptions).

A reclaim of VAT incurred on the following items is specifically prohibited:

- the purchase, lease, hire, acquisition or importation of passenger motor vehicles (except where such vehicles are considered to be inventory);
- the purchase of petrol (except where the petrol is considered to be inventory); and
- entertainment, food, drink, accommodation, or other personal services.

Sales of goods from Ireland which are dispatched to VAT-registered customers in another EU Member State, or exports to persons outside of the EU, are zero-rated.

Companies predominantly involved in the export of goods will tend to be in permanent VAT refund position (ie, VAT incurred on costs consistently exceeds VAT on sales). To eliminate this cash-flow cost, Ireland provides a unique regime for businesses whose revenues are at least 75% derived from the supply of goods to VAT-registered customers in other EU Member States, or to customers outside the EU. Such businesses may obtain authorisation from the Irish Tax Authorities to purchase most goods (including imports) and services, free of VAT. On receipt of the authorisation (known as VAT 56B Authorisation), the business gives a copy of this document to its suppliers and these suppliers are then permitted to apply 0% VAT to all supplies (with some limited exceptions), irrespective of the rate that would otherwise apply. The authorisation is available only to companies whose primary business activity is the supply of goods (as defined for VAT purposes). Companies whose primary activity is the supply of services do not qualify for this facility.

A business that is not established or registered for VAT in Ireland, but which incurs Irish VAT, may recover that VAT from the Irish Tax Authorities by filing a claim with the Tax Authorities in the jurisdiction in which the business is VAT registered and established. This facility is known as “Electronic VAT Refund” (EVR). EVR is also available, via Revenue Online Services (ROS) to Irish VAT registered and established businesses that incur VAT in other EU Member States (where they are neither VAT registered nor established). Non-EU established businesses may claim by way of the EU Thirteenth Directive. A refund of VAT on the specific non-deductible items, as outlined above, is prohibited.

An administrative arrangement known as a “VAT 60B” exists to enable Irish service providers to charge Irish VAT at 0% on continuous services supplied to certain foreign business customers. The authorisation is sent to the foreign business customer and in effect the supplier charges VAT at 0% on the particular service identified on the VAT 60B. This facility is of cash-flow benefit to the foreign customer who would otherwise have to make an EVR/Thirteenth Directive reclaim. As a result of change in place of supply rules for services effective since 1 January 2010, the VAT 60B mechanism is used only in limited circumstances.

Details of the current VAT rates are available on page 29 of the most recent edition of PwC’s publication *Tax Facts* (*PwC 2020 Tax Facts*) and currently range from 0% to 23%.

Tax issues associated with property investment in Ireland

Rental income

The rental income of an Irish tax resident company (or Irish branch of a non-resident company) is liable to corporation tax at the 25% passive rate, as opposed to the 12.5% rate that applies to trading profits. A non-resident company that does not operate through an Irish branch is liable to Irish income tax (as opposed to corporation tax) at the standard rate, currently 20%.

The net rental income that is liable to corporation tax is calculated similarly to the calculation of net profit under normal accounting principles. The main deductions allowed in arriving at the net rental income are:

- rates you pay to a local authority for the property;
- rents you pay for property such as ground rents;
- insurance premiums against fire and public liability;
- maintenance of your property such as cleaning, painting and decorating;
- property fees before you first rent out your property such as management, advertising, legal or accountancy fees;
- cost of any service or goods you provide that are not repaid by your tenant (such as electricity, central heating, telephone, service charges, water and refuse collection);
- certain mortgage protection policy premiums;
- expenses in between renting out the property in certain circumstances;
- capital allowances;

- repairs, such as rot treatment, mending windows, doors or machines;
- certain pre-letting expenses on vacant residential property; and
- the cost of registering with the Residential Tenancies Board (RTB).

In calculating the taxable net rental income, there is generally no deduction available for expenditure incurred before the first letting of the property. In addition, no deduction is allowed for expenditure of a capital nature – there are, however, specific provisions that grant relief for certain capital expenditure, which are discussed below in the section "*Tax depreciation*".

It should be noted that, in the case of rented residential property, the tax deduction for interest costs is dependent on the landlord's registration with the Private Residential Tenancies Board.

Where a net rental loss is incurred in an accounting period, the loss may be offset against other Irish source rental profits arising in the same accounting period, with any excess rental losses carried forward indefinitely for offset against rental profits arising in future accounting periods.

A further corporation tax surcharge of 20% applies to the net distributable rental and investment income of a "close company" if it does not distribute that income within 18 months of the end of the accounting period. A close company is defined as a company that is Irish tax resident and under the control of five or fewer participators (eg, shareholders and holders of certain debt instruments) and their associates, or alternatively under the control of any number of participators who are directors.

Withholding tax on rents

An Irish tax resident lessee/tenant must withhold tax at the standard rate of income tax (currently 20%) from rents paid to a non-resident landlord. Any tax withheld can be offset against the non-resident landlord's Irish tax liability, and a refund can be obtained of any excess. There is no requirement for the lessee/tenant to withhold tax from rents if the rents are paid to an agent in Ireland, who is acting on the non-resident landlord's behalf.

Tax depreciation

In calculating profits liable to Irish corporation tax, a deduction is not allowed for depreciation of capital assets. Relief may however be available for expenditure of a capital nature under various capital allowance regimes. Capital allowances are effectively a form of "tax depreciation".

Expenditure incurred on the construction/refurbishment of certain buildings may be eligible for capital allowances under the general Industrial Buildings regime. Capital allowances are calculated by reference to expenditure incurred on the construction or refurbishment of the building (excluding the cost of acquiring the land), and the rate at which the allowances can be claimed will vary depending on the use to which the building is put. For example, in the case of a building in use for the purposes of a manufacturing activity, capital allowances are generally available on a straight-line basis at an annual rate of 4% over a 25 year period.

Capital allowances are also available for capital expenditure incurred on certain items of plant and equipment. The allowances are, in general, available on a straight-line basis over an eight-year period. Accelerated allowances apply in the case of certain energy efficient equipment.

Capital gains tax

Capital gains tax (CGT) will apply to gains arising on the sale of any Irish property, irrespective of whether the vendor is tax-resident in Ireland. The gain arising is calculated by deducting the cost of the property (as adjusted for inflation if the property was acquired before 31 December 2002) from the net sales proceeds.

The adjustment to take account of inflation referred to above is known as "indexation relief". An indexation factor is applied to the actual base cost of an asset, determined by reference to the year in which the asset was first acquired, provided that the asset was acquired on or before 31 December 2002. It should be noted that limited indexation relief is available in the case of disposals of development land.

Capital gains tax clearance certificate

If the vendor does not provide a CGT clearance certificate, the purchaser is obliged to deduct 15% from the gross purchase price, where the purchase consideration exceeds 500,000 EUR or 1 million EUR in the case of residential dwellings. This amount must be paid to the Irish Tax Authorities by the vendor. Any tax withheld by the purchaser is available as a credit against the CGT payable by the vendor, with a refund of any excess.

A CGT clearance certificate is not required to be obtained by an Irish fund.

A CGT clearance certificate can be obtained from the Irish Tax Authorities where:

- the person making the disposal is tax resident in Ireland;
- no CGT is payable in respect of the disposal; or
- the CGT payable in respect of the disposal has been paid by the vendor, and the vendor has no other outstanding capital gains tax liabilities.

CGT exemption - Property incentive

Relief from CGT is available for gains arising on the disposal of properties purchased between 7 December 2011 and 31 December 2014. The relief is available in respect of gains arising on the disposal of properties located anywhere in the European Economic Area (EEA) by an Irish resident company/individual. The relief is also available in respect of gains arising on the disposal by a non-resident of properties located in Ireland.

The relief provides for a full exemption from CGT where the property is held for a minimum period of seven years. Where the property is held for a period in excess of seven years, the relief is allowed on a time apportioned basis. No relief is available if the property is not held for at least four years and up to a seven-year period.

The relief will not be available unless it can be shown that the property is acquired for a consideration equal to its market value (or not less than 75% of the market value if acquired from a connected person).

Shares deriving value from land in Ireland

A capital gain arising on the sale of shares in an unquoted company which derives the greater part of its value from land or buildings in Ireland is liable to CGT in Ireland, regardless of the tax residency of the vendor. The rate of tax applicable to capital gains is currently 33%. A CGT clearance certificate may be required in these circumstances.

The disposal of shares in a company that derives the greater part of its value from Irish land and buildings does not qualify for either the “Capital gains and holding companies - Participation exemption” or for the “CGT exemption - Property incentive” referred to above.

Property dealers/developers

An Irish tax resident company that carries on a trade of buying and selling property (a “property dealing” trade) is liable to corporation tax on its profits. The profits earned by Irish tax-resident companies, or by a branch or agency of a non-resident company, in a property dealing trade are liable to corporation tax at 25% rate, rather than the normal 12.5% rate applicable to trading income. Companies that are not tax-resident in Ireland, and who do not have a branch or agency in Ireland, are liable to income tax (as opposed to corporation tax) at the standard rate, currently 20%.

An Irish tax-resident company, or the Irish branch of a non-resident company, which develops and sells fully developed land, is liable to corporation tax at the standard rate, currently 12.5%.

Irish property funds

Ireland is renowned globally as being one of the premier locations for establishing and administering investment funds. This position is driven by the flexible, proactive regulatory environment in which Irish funds operate, the extensive industry experience and expertise in this area, and the high speed to market possible on the set-up of an Irish fund.

In recent years there has been an increased interest in Irish regulated property funds due to their tax-efficient nature. Authorised Irish funds are not subject to Irish tax on their income and gains. Furthermore, provided the appropriate documentation is in place, income and gains can be paid to non-resident investors, without deduction of WHT, regardless of the tax residency position of the investor.

It is possible to structure a regulated real estate fund vehicle with significant flexibility in terms of investment mechanics, few investment restrictions and no borrowing or leverage limits.

It is possible to “check the box” to treat an Irish fund structured as an ICAV as transparent for US tax purposes.

The financial regulator has agreed a number of key policy changes designed to improve Ireland’s attractiveness as a location for property funds, including the ability to establish multi-layered special purpose vehicle (SPV) structures. There are a variety of legal and fiscal reasons why it may be beneficial for a fund to own real estate indirectly via a wholly owned subsidiary/wholly owned SPV or multiple layers of subsidiaries/SPVs. These changes have resulted in greater opportunities for structuring regulated property funds in Ireland.

Irish real estate funds (IREFs)

Finance Act 2016 introduced a new taxation regime for Irish regulated funds deriving more than 25% of their value from Irish land or buildings. This test is applied at a sub-fund as opposed to an umbrella level. The regime came into effect from 1 January 2017. Where a fund is classified as an IREF, a 20% withholding tax must be operated by the fund on income distributions and gains on redemptions paid to non-exempt investors.

Provision is made for an exemption from the operation of withholding tax on payments by IREFs to certain categories of investor eg, Irish pension schemes, life assurance companies and regulated funds and their EEA based equivalents.

Provision is made to prevent a double charge to IREF withholding tax in a situation where one sub-fund in an umbrella scheme invests in another sub-fund in the same umbrella scheme.

There is also an advance clearance system which allows investors who would be in a position to claim a full refund of tax suffered, to apply to Revenue for upfront clearance and to receive payments gross of tax. This prevents direct investors having tax withheld where they would be entitled to a full refund of the tax withheld.

Provision is also made for intermediaries to complete declarations on behalf of certain exempt investor classes including pension funds, charities and credit unions.

Finance Bill 2019 introduced a number of amendments to the existing IREF regime which introduces a tax charge in the hands of the ICAV in certain scenarios.

The first of these measures provides that financing costs attributable to 'excess debt' incurred by the ICAV, excess debt being borrowings exceeding 50% of the relevant cost of the IREF assets, will be considered deemed income at the level of the ICAV. This deemed income will be subject to income tax at the rate of 20% in the hands of the ICAV.

The second of the measures aimed at reducing the quantum of interest payable by an IREF introduces a minimum financing cost ratio of 1.25 which must be maintained.

Where the finance cost ratio is below 1.25 for a given period, the ICAV will be deemed to have received income equal to the amount by which the adjusted financing costs would have to be reduced in order to achieve a financing cost 1.25, and this income will be subject to income tax at a rate of 20%.

Other IREF measures introduced in the Finance Bill include a provision whereby expenses incurred not wholly and exclusively for the purposes of the IREF business will result in a deemed income at the level of the IREF.

VAT on property

The VAT legislation relating to immovable property underwent a significant overhaul in 2008 and "new" rules have been in place since July 2008. The "new" rules resulted in fundamental changes in the way VAT is applied to property transactions.

Sale of new property – Taxable sales

Currently, under Irish VAT law, the sale of non-residential property (including a freehold equivalent interest whereby the person may have a right to dispose of the property as owner) is subject to VAT, provided it is the:

- first sale within five years from completion of the property; or
- second or subsequent sale within five years following completion provided the property has not been occupied for an aggregate of 24 months.

Where the sale is taxable, VAT at the reduced rate (currently 13.5%) will be charged by the vendor.

Exempt sales

The following sales (freehold and freehold equivalent interest) are exempt from VAT:

- an undeveloped property;
- a property not developed within the last five years;
- a property developed within the last five years but where the development was considered "minor" in nature (certain conditions must be met); and
- a second or subsequent sale of the property within five years and where the property has been occupied for an aggregate of 24 months.

However, a vendor and purchaser can exercise a “joint option for taxation” on a property that would otherwise be an exempt sale. This may be exercised to prevent a clawback under the Capital Goods Scheme (see below). If the joint option for taxation is availed of, the purchaser must account for the VAT on the consideration on a “reverse charge” basis.

The first sale of a residential property by the person who developed it in the course of business (eg, a property developer) or by a person connected with the property developer will always be subject to VAT at the reduced rate, currently 13.5%.

Lettings

All lettings irrespective of their duration, are exempt from VAT. The landlord may opt to tax the letting and must notify the tenant in writing or provide for the option to tax in the letting agreement. An option may be exercised to avoid a clawback under the Capital Goods Scheme (see below).

The option to tax cannot be exercised in respect of residential property or lettings to connected parties/occupiers (except where the connected tenant/occupier is entitled to at least 90% VAT recovery).

The option to tax is specific to each letting. When the option is exercised, VAT at the higher rate (currently 23%) is levied on rents as they fall due.

Please note that a transfer of a long leasehold interest (eg, 999 year lease), generally referred to as a “freehold equivalent interest” which transfers in substance the rights to dispose of the immovable goods is regarded for VAT purposes as a sale of the property as opposed to a letting.

Capital Goods Scheme (CGS)

The Capital Goods Scheme is a mechanism for regulating deductibility over the “VAT life” of a capital good. For VAT purposes, a capital good is a developed property or further development work on a previously completed property, ie, refurbishment. The CGS ensures that the deductibility of VAT associated with a property correctly reflects the use of the property.

The VAT incurred on the acquisition or development of a property is deductible in accordance with the normal rules of deductibility. The VAT life of the property is divided into intervals – 20 intervals for new/redeveloped properties and ten intervals for refurbishment, with each interval essentially equating to 12 months. The VAT initially deducted on the acquisition or redevelopment of a property will be subject to review and possible adjustments (time apportioned) over the VAT life of the property.

After each interval, the business must review its VAT recovery entitlement in respect of that capital good. If the recovery entitlement (taxable use) has decreased, the business must repay a proportion of the VAT previously deducted in respect of that interval. If the recovery entitlement has increased, the business can get an additional VAT deduction (assuming all of the input VAT was not deductible at the time of purchase). In the case of a major change in use of the property, an accelerated payment may be required under the CGS or accelerated recovery may be possible under the CGS.

The CGS applies to sales of freeholds and freehold equivalent interests. If a sale is exempt, a clawback may arise under the CGS, whereas if a sale is taxable (for example, by way of a joint option for taxation), an additional VAT credit may arise for the vendor (assuming all of the input VAT was not deductible at the time of purchase). The CGS also applies where an option to tax a letting is exercised and subsequently cancelled.

Transitional rules apply to certain properties under construction at 1 July 2008 and to occupational leases granted prior to 1 July 2008.

As the area of property taxation is complex and the legislation is subject to frequent change, specialist VAT advice should be obtained on all property-related transactions.

Sale of loan books

The sale of a loan portfolio secured on immovable property is considered a transfer of debt and is exempt from VAT. Any costs incurred either by a transferor or a transferee in connection with the disposal or acquisition of a loan portfolio will not be deductible.

Stamp duty on transfers of property

Stamp duty is payable on the transfer of most forms of property where such transfer is effected by way of a written document. In the absence of a written document, no charge will generally arise.

Duty of 1% applies on the transfer of common stock or marketable securities of an Irish company, where the value of the shares transferred exceeds 1,000 EUR.

Duty of 1% applies on the transfer/purchase of residential property where the value of property does not exceed 1 million EUR. Where the value of the property exceeds 1 million EUR, duty of 2% applies on the excess.

Duty of 7.5% applies on the transfer of stocks or marketable securities in certain companies (including non-Irish incorporated companies) deriving their value from Irish commercial property where the commercial property is held as trading stock or was acquired/is being developed with a view to realising a gain on disposal, and the transfer of the stocks or marketable securities results in a change in control over the company. This 7.5% rate also applies to transfers of interests in funds and partnerships holding Irish commercial property in similar circumstances.

As indicated in Finance Act 2019, the stamp duty rate on transfers of non-residential property has increased from 6% to 7.5%, in respect of instruments of transfer executed on or after 9 October 2019.

Stamp duty relief is available for transfers arising from corporate reorganisations and reconstructions effected for bona fide commercial reasons. In addition, no duty arises on transfers between associated companies (90% direct or indirect relationships), subject to conditions. An extensive number of other exemptions are available, including for transfers of IP, a wide range of financial instruments, foreign land and foreign shares.

The sale of mortgages secured on Irish property is not liable to Irish stamp duty. In addition, the sale of a loan portfolio not secured on Irish property may be exempt from stamp duty where a number of conditions are met. If the stamp duty exemption is not available, then a charge to stamp duty at a rate of 7.5% would apply on the higher of the consideration paid or the market value of the loan portfolio.

Relevant contracts tax (RCT)

RCT is a withholding tax whereby a person known as a “principal contractor” is obliged to retain tax from amounts payable to sub-contractors engaged to carry out “relevant operations” in Ireland. If relevant operations are carried out in Ireland, RCT applies to the contract regardless of the residence of the subcontractor.

RCT should be operated by businesses defined as principal contractors. A principal contractor may include property developers, building companies and all associated building trades, as well as individuals who are connected with these businesses.

All government bodies, local authorities, public utilities, boards and bodies established under statute are deemed to be principal contractors under current legislation. It also includes all gas, water, electric/hydraulic power (eg, wind farms), dock, canal and railway activities.

From 31 March 2012, companies and individuals who carry out work on the installation, alteration or repair of telecommunications systems are now specifically included in the definition of a Principal.

A person or company is also deemed to be a principal contractor where they sub-contract all or part of a relevant contract under which they are a sub-contractor for RCT purposes.

Where a principal receives certain services, RCT should be operated on payments made to the service provider.

The range of services included in the scope of RCT is very broad and can bring some service providers into the realm of RCT unexpectedly, for example telecommunication hardware suppliers, hauliers and offshore exploration/exploitation support services.

There are three rates for RCT:

- The 35% rate applies to subcontractors who are not yet registered with Revenue and for subcontractors who have outstanding compliance issues.
- The 20% deduction rate applies to subcontractors who are registered with Revenue and have an established compliance record.
- There is also a zero per cent rate which applies to subcontractors who satisfy certain Revenue requirements.

Local authority taxes on business property

Property taxes, known as rates, are imposed by Local Authorities (city corporations, urban and county councils) on the owners or occupiers of land and buildings used for business purposes. Rates are based on the valuation of the building and the level of the rates is fixed annually by reference to the budgetary requirements of the relevant Local Authority for facilities such as sanitation, public lighting, road maintenance, etc.

All commercial enterprises are charged water rates. Water usage is normally metered for larger companies and a charge made per 1,000 litres of water used. The charge varies from Local Authority to Local Authority. Some smaller users may be charged on a fixed basis rather than a metered basis.

Municipal tax system

Commercial rates are levied by local authorities on commercial and industrial property. The rates payable on a specific property are determined with reference to a valuation provided to the relevant local authority by the Valuations Office.

While it is the central Government that dictates the method of rate calculation, rateable properties and persons liable for rates, etc, it is each Local Authority that publishes the valuation roll containing valuations of all properties within their jurisdiction. The Local Authority also calculates the final rates liability and arranges for collection of the rates.

The income collected from rates is used to fund the services provided by the local authorities such as housing, water supply, disposal of commercial waste, maintenance of parks and public areas, public lighting, etc.

Properties liable to rates

The properties assessed for rates are limited to industrial and commercial properties including buildings, land, railways, tolls, shops, factories, etc on the condition that the property is either:

- occupied; or
- unoccupied, but capable of being the subject of rateable occupation by the owner of the property.

Who pays rates?

Generally, the person in occupation of rateable property on the date the rates liability arises is liable for the rates. Exceptions to this are:

- rates levied on the owner of property, vacant at the date of charging the rates;
- where the person who had liability for rates defaults on payment, a subsequent occupier can be held liable for up to two years' rates arrears owed by the previous occupier.

Lease agreements typically provide that the tenant is the person liable for any rates' liability that arises on the property, although this varies depending on the actual terms of the agreement reached between the parties.

Calculation of the rates' liability

The liability arising is assessed by multiplying the rateable valuation (see below) by the rateable valuation multiplier set by the local authority.

Properties in all local authorities are currently being revalued under the National Revaluation Programme. To date, revaluation has been completed in Carlow, Dun Laoghaire-Rathdown, Fingal, Kildare, Kilkenny, Laois, Leitrim, Longford, Offaly, Roscommon, Sligo, South Dublin and Westmeath County Councils and Dublin City Council, Waterford City and County Council and Limerick City and County Council rating authority areas.

Revaluation is currently taking place in Cavan, Louth, Meath, Monaghan, Tipperary, Wexford and Wicklow County Councils. The project is called "Revaluation 2019" as all ratepayers in these areas will receive their final Valuation Certificates in 2019 effective for rates purposes from 2020 onwards.

Rateable valuation

The rateable valuation is based on the letting value of the property. For the purpose of valuation, fixed plant is taken into account and included in the value of the relevant property. Plant is assessed by reference to its construction/replacement cost together with an agreed formula for site value. In the case of industrial property, more complicated valuation rules apply, and detailed advice would be required.

The rateable valuation of a property in a local authority area where a revaluation has already taken place is based on the rent that the property might be able to generate from being let during the year.

However, the rateable valuation of a property in a local authority area where a revaluation has not yet been carried out is calculated based on the annual rent that the property could reasonably be expected to command discounted

to an estimated letting value as at a prescribed date (in accordance with legislation). A percentage factor is applied to this valuation to arrive at a rateable value. The percentage factor depends on where the property is situated.

For example, the rateable valuation of a property in a local authority area where a revaluation has already been carried out, eg, Dublin City, may be 100,000 EUR.

In comparison, the rateable value of a property where a revaluation has not yet occurred, eg, Cork City, would be calculated as follows:

Estimated rental value	**50,000 EUR**
Adjust by percentage, eg,	0.5%
Rateable value	250 EUR

Rateable valuations are determined by the Valuation Office, which is independent of the local authorities, but is ultimately controlled by Government. Where a person is not satisfied with the valuation of their property, they have the right to appeal through a formal appeals process.

Rateable valuation multiplier

The rateable valuation multiplier is fixed each year by the relevant county or city council. The multiplier will also depend on whether a revaluation has been carried out in that local authority yet. For illustrative purposes a sample of rateable valuation multipliers is set out below:

City	**Multiplier (2020)**
Cork	74.75
Galway	67.40
Dublin	0.2680
Limerick	0.2677
Waterford	0.2648

If, for example, the property was situated in Cork City, the annual rates liability would be calculated as follows (based on the above figures):

Rateable value	**250 EUR**
Multiplier applying in 2020	74.75
Annual rates liability	18,587.50 EUR

If the property was situated in Dublin City, the annual rates liability would be calculated as follows (based on the above figures):

Rateable value	**100,000 EUR**
Multiplier applying in 2020	0.2680
Annual rates liability	26,800 EUR

Exemptions

Certain properties, although valued, are exempt from the payment of rates. Such properties are outlined in Schedule 4 of the Valuation Act 2001 and include properties occupied by the State, churches, hospitals and buildings used for charitable purposes.

Valuation Act 2001

The Valuation Act 2001 was introduced for the purpose of simplifying the valuation system, improving both equity and transparency for ratepayers. One of the key features of the Act is the provision to base valuations on the full current open market annual rental value of the property.

The Act also provides that all commercial and industrial property should be revalued by reference to market conditions. These valuations will be published and available for public inspection. Given greatly increased property values over recent years, revaluations under the Act are likely to produce increases in the rateable valuation of most properties.

The Valuation (Amendment) Act 2015 amended the Valuation Act 2001 to include new measures to accelerate the National Revaluation Programme, for example, the introduction of occupier-assisted valuation of a property (a form of self-assessment).

Local property tax

An annual local property tax (LPT) charged on all residential properties in Ireland came into effect in 2013. Residential property is any building or structure (or part of a building) which is used as, or is suitable for use as, a dwelling and includes grounds of up to one acre. The LPT does not apply to development sites or farmland.

The LPT is a self-assessment tax and is based on market value bands. The first band covers all properties worth up to 100,000 EUR. Bands then go up in multiples of 50,000 EUR. If a property is valued at 1 million EUR or lower, the tax is based on the mid-point of the relevant band. For properties valued over 1 million EUR the tax is charged on the balance over 1 million EUR. The basic LPT rate was set at 0.18% for properties valued under 1 million EUR and 0.25% on the amount of the value over 1 million EUR.

Valuation band (in euro)	Mid-point (in euro)	Standard rate (in %)	Standard LPT payment (in euro)
0 - 100,000	50,000	0.18	90
100,001 - 150,000	125,000	0.18	225
150,001 - 200,000	175,000	0.18	315
200,001 - 250,000	225,000	0.18	405
250,001 - 300,000	275,000	0.18	495
300,001 - 350,000	325,000	0.18	585
350,001 - 400,000	375,000	0.18	675
400,001 - 450,000	425,000	0.18	765
450,001 - 500,000	475,000	0.18	855
500,001 - 550,000	525,000	0.18	945
550,001 - 600,000	575,000	0.18	1,035
600,001 - 650,000	625,000	0.18	1,125
650,001 - 700,000	675,000	0.18	1,215
700,001 – 750,000	725,000	0.18	1,305
750,001 - 800,000	775,000	0.18	1,395
800,001 - 850,000	825,000	0.18	1,485
850,001 - 900,000	875,000	0.18	1,575
900,001 - 950,000	925,000	0.18	1,665
950,001 - 1,000,000	975,000	0.18	1,755

Properties worth more than 1 million EUR are assessed on the actual value at 0.18% on the first 1 million EUR and 0.25% on the portion above 1 million EUR.

From 2015 onwards, local authorities can vary the basic LPT rate on residential properties in their administrative area. The basic rates of LPT are 0.18% and 0.25%. These rates can be increased or decreased by up to 15% (both rates must be adjusted by the same amount). This is referred to as the local adjustment factor.

The introduction of the local adjustment factor means that residential properties of the same value in different local authority areas may pay different amounts of LPT from 2015 onwards if the local authority has applied a local adjustment factor.

If a local authority passes a resolution to vary the basic LPT rates of 0.18% and 0.25% for 2020, Revenue must have been notified of the local adjustment factor on or before 30 September 2019. The local authority must also publish a notice of the variation of LPT on its website and in at least one local newspaper. Revenue then adjusts the LPT liability for residential properties within the local authority's administrative area.

EU ATAD

The Anti-Tax Avoidance Directive (ATAD) was formally adopted by the Economic and Financial Affairs Council of the European Union on 12 July 2016.

The ATAD comprises five operative components: interest limitation rules, controlled foreign company (CFC) rules, exit tax, general anti-abuse rule (GAAR) and anti-hybrid rules.

Anti-hybrid mismatch rules came into force in Ireland from 1 January 2020. The rules broadly deny deductions or impose tax on transactions between associated entities where there is an element of hybridity in the transaction or due to the form of the payor/payee.

Interest limitation rules under ATAD have not yet been implemented into Irish legislation. The rules would impose a cap on interest deductions to no more than 30% of EBITDA.

Finance Act 2019 transposed the EU Directive on the mandatory disclosure of certain crossborder arrangements (known as "DAC6") into the Irish tax code. The new provisions align very closely with the Directive and operate in addition to our domestic mandatory disclosure regime which was introduced with effect from 2011. The Directive came into force on 25 June 2018 and it applies from 1 January 2020.

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Real Estate Tax Summary

General

A foreign investor may invest in Israeli real estate directly, or through an Israeli or foreign company, a branch or partnership.

Rental income

Rental income accrued or derived in Israel is taxable in Israel under the Israeli Income Tax Ordinance.

Rental income is recognised for tax purposes either on the accrual basis or on the cash basis, according to the status of the taxpayer and the scope of the activities. However, passive rental income, including such income received in advance, is generally taxable on a cash basis. Rental income from an active rental business operation is generally reported on an accrual basis.

In principle, expenses, but generally not of a capital nature, are deductible against rental income if they are incurred wholly and exclusively in the production of taxable income, eg, insurance, maintenance, property management. A withholding tax (WHT) of 23/25% may be imposed, subject to any tax treaty reduction, in the case of certain overseas expenditures, such as interest on borrowings. Alternatively, a foreign lender who incurred proven costs in the course of its earnings of such interest income can request to pay tax at regular rates on its net margin.

Taxation of rental income

Taxable rental income accrued or derived in Israel, less expenses, is subject to tax at the following rates.

For the year 2020, companies are taxed at the corporate tax rate of 23%. (Please note that for companies that are treated as “approved enterprises”, different corporate tax rates may apply).

Dividend distributions to a foreign resident are generally subject to a 25%-30% WHT (30% if paid to a 10% or more shareholder of a non-publicly traded company) or to a lower treaty rate where applicable. For example, currently (2020), regular profits of 100 for an Israeli company will provide a net, ie, after tax, dividend income of 53.9 (57.75 where the 25% WHT rate applies). This is 100, minus 23 company tax and 23.1 dividend WHT, assuming the absence of a reduced rate due to a treaty.

Individuals are taxed at rates of 31% to 47% for passive rental income. In addition, individuals are taxed at rates of 10% to 47% in the case of rental income from an asset that the individual has used in the production of income, derived from their self-employment or business, for at least ten years prior to the rental. Furthermore, the 10% to 47% rate applies to individuals who reached age 60 in the tax year or are older than 60 years.

Individual landlords of residential homes are eligible, under certain conditions, to select one of the following taxation alternatives:

- Individual landlords are eligible, under certain conditions, for a complete exemption from income tax for rental income (from Israeli homes) not exceeding a prescribed amount per month (currently 5,010 Israeli shekel or ILS). No special approval is needed to qualify for this exemption. If the rental income is higher than the prescribed amount, then a certain portion of the rental income will be taxed at the individual’s marginal tax rate.
- Individual landlords are eligible, under certain conditions, to elect to pay tax at the rate of 10% on their gross rental income from homes (no deductions, set-off losses or tax exemptions are allowed).

There are no debt/equity limits at present in the case of regular activities in Israel. Special tax and other benefits and minimum equity rules apply to approved properties (see section “*Incentives*” below).

Depreciation

Depreciation is generally allowable on a straight-line basis for expenditures on buildings, but not on land, at the following annual rates:

- building owned by an industrial company or a hotel - 5% (based on regulations that should be extended); and

- other buildings - 4% (Accelerated rates of depreciation are available for owners of certain properties.).

Loss carryforward

Passive losses from leasing a building may only be used to offset rental income from buildings in the current year and only from the same building in future years, or land appreciation realised upon disposal of that building. When prepaid rental payments have been subject to tax in an earlier year, as discussed above, the related expenses incurred in subsequent years are allowed as an offset in the year in which they were incurred against income from any source. In the absence of such other income, the losses may be carried back and be used to offset the prepaid rental income.

Losses from an active property rental business operation may be used to offset other taxable income in the same year from any source, or against future active business income and certain capital gains.

Gains from the sale of Israeli real estate

Land appreciation tax (LAT) is imposed on gains from the sale of Israeli real estate. LAT is also imposed on the sale of an interest in a non-traded real estate association (REA), defined as a company or partnership whose principal assets consist of Israeli real estate. However, the tax liability arising from the sale of such an association will be determined, based on the capital gains tax provisions of the Israeli Income Tax Ordinance. For LAT purposes, a sale includes most types of dispositions, as well as the grant of a lease capable of lasting for 25 years or more.

In measuring the lease period, an option to lease is considered as if exercised. Detailed expenditure deduction rules are prescribed for LAT purposes.

The resulting taxable capital gain is divided into real and inflationary elements.

The real capital gain is taxable as follows:

- Assets purchased from 7 November 2001 and thereafter:
  - The tax rate applicable to real capital gains derived from the sale of an interest in real estate (and in REAs that enjoyed this status for at least five years prior to the sale) for individuals is 20% and for corporations the rate is 23%. However, according to tax legislation published on 6 December 2011, the portion of the gain for individuals attributed to the period between 31 December 2011 and the sale date shall be taxed at the rate of 25% (30% for shareholder which holds 10% or more in a real estate company).
- Assets purchased prior to 7 November 2001 – for individuals:

Capital gains arising from the sale of an interest in real estate (and in REAs) by an individual shall be apportioned on a linear basis to the periods before and after 7 November 2001.

  - The portion of the gain attributed to the period before 7 November 2001 shall be subject to tax at the taxpayer's marginal tax rate up to 47% (2020).
  - The portion of the gain attributed to the period between 7 November 2001 and 31 December 2011 shall be taxed at the preferential rate of 20%.
  - The portion of the gain attributed to the period between 31 December 2011 and the sale date shall be taxed at the rate of 25% (30% for shareholder which holds 10% or more in a real estate company).
  - A special tax rate may apply with respect to real estate acquired prior to 1960. Certain rules apply.

The inflationary amount is equal to the original cost of the asset, less depreciation where applicable, multiplied by the percentage increase in the Israeli consumer price index (CPI) from the date of the acquisition of the asset to the date of its sale. This inflationary amount is exempt to the extent it accrued on or after 1 January 1994 and is subject to tax at a rate of 10% to the extent it accrued before then. When determining the inflationary amount, foreign residents who invested in foreign currency may opt to use the relevant foreign currency exchange rate instead of the CPI.

Capital losses

Capital losses realised as from 1996 might be used to offset capital gains, including land appreciation, realised in the current tax year or in future years.

Exemptions and deferrals

Exemption on disposal of a home in Israel

Full or partial exemption from land appreciation tax may be available to an individual, a resident of Israel upon the disposal of a home in Israel. This exemption is available, provided that the seller was not entitled to the tax benefits relating to approved rental buildings, or that the home constituted inventory for income tax purposes. A home is generally defined as a dwelling or part of a dwelling, the construction of which has been completed and which is owned or held by lease by an individual and which is used for residential purposes. Detailed qualifying rules apply. The exemption for non-residents is very limited.

Deferral (rollover) of land appreciation tax

Certain transactions may give rise to a deferral, or rollover, of liability for land appreciation tax, if the seller was not entitled to the tax benefits relating to approved rental buildings. In general, qualifying transactions include, among others, the following:

- A transfer of real estate rights without consideration by an individual to their relative, which is not an association under their control.
- A transfer of real estate rights without consideration (rather than shares) by their owners to an association that is a REA, or which becomes one as a result of the transfer.

Incentives

Approved property status was granted for projects for building and leasing industrial, commercial or residential buildings or combinations thereof, subject to the fulfilment of certain conditions. According to an update in a tax legislation published on 16 December 2009, properties receiving this status may enjoy the tax benefits, as set out below.

Approved rental property and approved industrial building

Accelerated depreciation is available in respect of approved properties.

Taxable rental income derived from an approved residential building owned by a corporate entity is generally subject to corporate tax at a rate of 23% (or 11% if certain conditions are met) for an unlimited period. From 2010 onwards, when more than 25% of a company's share capital, shareholders' loans and related rights are owned by foreign investors, and, if the company owns an approved rental building, the company may qualify as a foreign investors' company, which, depending on the level of foreign ownership, may provide for a company tax rate as low as 10%-18%.

Dividends paid to shareholders of an Israeli incorporated company from the income of an approved residential building are subject to a WHT of 15%/20%.

For approved industrial buildings, taxable benefits include company tax rates ranging from 25% to as low as 10%, where the level of foreign investment is 90% or more. A tax holiday was allowed to be elected in certain circumstances. These beneficial tax rates are similar to those applicable to rental income of approved rental buildings.

2007 new law approved rental property incentives

In March 2007, a new law came into force, which provides significant tax benefits for Israeli companies that own residential buildings, meeting certain conditions (eg, the building must have at least 16 rental apartments averaging not more than 100 square metres and the building must be used by the company for at least ten years as a rental property only).

The principal benefits include the following:

- exemption from LAT upon the sale of the building, provided certain conditions are met;
- accelerated depreciation up to 20% annually; and
- ability to offset rental losses from the buildings as business losses.

Exemption for transfer of shares in real estate association (REA) to foreign shareholder

A foreign company owning shares in a REA may transfer its shareholdings in the REA to its shareholders in a manner that is exempt from LAT and transfer tax. Detailed rules apply.

Value-added tax (VAT)

VAT is generally imposed on transactions conducted in Israel, as well as transactions relating to assets or activities in Israel. The standard rate of VAT in Israel is currently 17%. However, no VAT is imposed on an individual's purchase of a residential unit (apartment/house) from another individual.

Residential rental transactions for a period not exceeding 25 years are exempt from VAT. However, the consequences of exemption on such output, is that input VAT relating to attributable costs, may not be recoverable. Other real estate rental and sale transactions will generally be subject to VAT, in which case the attributable input VAT should be recoverable through the normal VAT mechanism.

Transfer fees (acquisition tax)

While the seller of real estate is generally liable to LAT, the transfer fees are generally payable by the purchaser of real estate. These fees are currently payable at the following rates:

Transfer fee	**rate (in %)**
Regular rate	6
Apartment/house intended for residential use	
first and only home	0
and exceeding the amount of 1,744,505 ILS	3.5-10
additional home	5-10
New immigrants – apartment/house and business	0.5 and 5
Premises	special concessionary rate subject to conditions

Transfer fees are not imposed on the acquisition of shares in a corporate REA, which are publicly traded on the Tel-Aviv Stock Exchange.

Miscellaneous taxes

Municipal betterment levies and fees are imposed on the assessed increase in value resulting from the rezoning of land and on planning permit applications. There are also annual municipal taxes and license fees on buildings.

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Real Estate Tax Summary

General

In the Italian tax system, real estate property is generally deemed to produce taxable income, even if not used by the owner or even if not leased out. This income is subject to taxation in the hands of the owner of the real estate, in property or by virtue of another real right, according to his nature and tax status, characteristics and use of the real estate.

Investments in Italian real estate properties can be executed directly, with acquisition of the property right by the individual/corporate investor (resident or not resident), or indirectly, through the acquisition of interest in Italian real estate vehicles.

Direct investments

Rentals are taxed following the income taxes rules applicable to the owner of the real estate without deduction of acquisition/owning costs (with a few exceptions). For real estate not leased out, the taxable base may be the cadastral (deemed) income (with some exceptions).

Capital gains upon disposal of real estate are generally taxed following the income taxes rules applicable to capital gains. However, if the sale occurs after five years from acquisition/construction (with some exceptions) capital gains are tax-exempt. Acquisition, owning and certain other costs may increase the purchase cost of the property and therefore decrease the capital gain on disposal.

For direct investments, depending on the nature of the investor, among others, the following matters have to be considered:

- individuals
  - individuals (resident and non-resident) are subject to personal income tax (IRPEF), which applies at rates increasing by brackets of income (from 23% to 43%, with the maximum rate applicable from 75,000 EUR of aggregated taxable income), and to local surcharges (up to 4.23%);
  - for residential buildings leased out, an option for a favourable substitute tax regime (*cedolare secca*), alternative to the ordinary taxation, may be elected; the substitute tax applies with rate of 21% (reduced to 10% in some circumstances) on the rents;
  - local property tax (IMU) is due; it is not tax deductible, but it replaces income taxes in the case of not leased properties (with some exceptions).
- companies
  - non-resident entities other than individuals (the resident ones, as they may be also the investment vehicles, are considered in the indirect investment) are subject to corporate income tax (IRES) with a rate equal to 24%; the taxable base is the same ordinarily stated for individuals;
  - local property tax (IMU) is due and it is generally not tax deductible, except for IMU due on instrumental/ commercial buildings which is, for IRES purpose, 60% deductible for fiscal years (FYs) 2020 and 2021 and fully deductible from FY 2022 onwards.

Indirect investments

Indirect investments are made through the acquisition of interest in companies holding real estate properties. Generally, the preferred legal form is the limited liability company without shares (S.r.l.) which, with regard to corporate governance, is more flexible than the company limited by shares (S.p.A.).

For Italian property companies, rentals are generally subject to IRES and regional tax on production (IRAP) following the business income tax rules, with possibility to deduct related costs (some limits are stated).

Capital gains upon disposal of real estate are always subject to IRES and IRAP, with the exception of sale of a going concern (always exempt from IRAP).

Indirect investment generates income having financial nature: dividends from net profits distribution and capital gains from shareholdings disposal. The taxation of such income in Italy varies according to the kind of shareholding

and tax status of the beneficiary. In this respect, tax treaties against double taxation may allow reductions or exemptions.

In certain circumstances, exemption is directly provided by the Italian domestic legislation.

The following matters have to be considered:

- Limited companies are subject to IRES at the rate of 24%, and IRAP at the rate of 3.9%.
- The IRES taxable base is computed by applying, to the pre-tax result of the P&L account of the relevant tax period, the increasing and decreasing adjustments provided for by the business income tax rules.
- The IRAP taxable base (ie, “value of production”) is broadly represented by the company’s gross margin in P&L account. Therefore, the following items are generally excluded from IRAP (ie, income not taxable / costs not deductible): interest income, interest expenses, provisions for bad debts, other provisions for risks and liabilities, items not related to the business activity, labour costs, with the exception of social contributions and costs concerning open-ended jobs that are fully deductible.
- Depreciations are always deductible for IRAP purposes while are subject to certain limits for IRES.
- Interest expenses are deductible for IRES purposes within the limits stated by the thin capitalisation rules (capped yearly to 30% of the “rectified”/tax EBITDA of the company); conversely interests are fully not deductible for IRAP.
- Tax loss carry-forward is admitted for IRES purposes only, with different limits depending on the period of incurrence; carry-back is not admitted in the Italian tax system.
- Local property tax (IMU) is due and it is not deductible for IRAP purposes. Conversely, in the case of instrumental properties (ie, offices, retail areas, etc) 60% of local property tax paid can be deducted for IRES purposes for FYs 2020 and 2021 (fully deducted from FY 2022 onwards).
- Specific attention has to be given to the non-operating companies’ legislation, which aims to tax companies deemed non-operating on the basis of their assets for both IRES and IRAP purposes. The non-operating status is determined on the basis of the actual proceeds and systematic loss position.

Indirect taxes

The acquisition of Italian properties is generally subject to VAT and transfer taxes (ie, registration, mortgage and cadastral taxes), with different rules, according to the nature of the property and the subjects involved.

Nevertheless, the transfer of interest into Italian real estate companies does not imply transfer of the properties and transfer taxes generally fall due in nominal fixed amount.

Also lease and financing agreements may have implications in terms of VAT and indirect taxes (in principle, registration tax; also, mortgage tax for loans guaranteed by mortgage).

Further real estate investments

Alternatives to the direct acquisition of Italian real estate properties and to the acquisition of interest in real estate companies owning such properties may be the investment in Italian institutional investors operating professionally in the real estate industry, such as:

- investment into units of an Italian real estate investment fund (*FIA immobiliare*), contractual closed-end alternative investment fund;
- investment into shares of an Italian SICAF (*società di investimento a capitale fisso*), corporate closed-end alternative investment fund, incorporated in the form of S.p.A.;
- investment into shares of an Italian SIIQ (*società di investimento immobiliare quotata*), the Italian version of the better known REITs in force in other countries.

Real Estate Investments

Direct investment in Italian real estate property

Legal aspects

In principle, a foreign private individual/company has the faculty to purchase a real estate property in Italy.

Usually, foreigners make real estate investments directly for residential use and through a special purpose vehicle (SPV) for commercial activity, especially for tax purposes.

For these investments, the Italian Civil Code contains a general legal provision concerning the "treatment of foreigners", pursuant to which "foreigners enjoy the civil rights attributed to citizens on condition of reciprocity and subject to the provisions contained in special statutes. This provision also applies to foreign entities".

Such "reciprocity principle" is considered to be the discriminating element in force which determines whether a foreign subject (private individual/company) may, or may not, purchase a real estate property in Italy.

At present, only a few countries do not satisfy the reciprocity conditions with Italy (by way of example and without limitation: Afghanistan, Bahamas, Congo, Liberia, Iraq, Madagascar and Myanmar).

Useful information to check whether the "reciprocity principle" is met or not, can be found on the following website of the Italian Ministry of Foreign Affairs where a country list is posted (available in Italian only): www.esteri.it/mae/it/servizi/stranieri/elenco_paesi.html.

Ownership in compliance with the Italian Constitution

The Italian Constitution, issued on 27 December 1947, which came into force on 1 January 1948, expressly distinguishes between public and private ownership.

Ownership has to be considered as a continuous right and not subject to prescription.

Ways to acquire a real estate ownership

In accordance with the Italian Civil Code, ownership is acquired by two different means:

Original acquisition

Accession
Accession operates in the case of the incorporation of goods (generally, the inclusion of a secondary property into a main property), owned by different owners, due to human activity, or due to natural events. As a general principle, the owner of the soil acquires the ownership of any work, or structure performed under, or upon the mentioned soil.

Adverse possession
The ownership of real estate property – together with the other real rights of enjoyment regarding the property – is acquired through the continuous possession without interruption for: (i) 20 years (ordinary term); (ii) 10 years from the date of transcription of an instrument suitable for transferring real estate ownership when the relevant acquisition is achieved in good faith from a person who is not the real owner of the property transferred.

Derivative acquisition

Agreement
The acquisition of real estate ownership determines the taking over of the same right of the previous owner.

Mortis causa succession, which is ruled by the legal provisions relating to the individuals whose inheritance is involved, at the time of the death.

Compulsory sale of the debtor's property
Compulsory sale of the debtor's goods, which may occur at the end of judicial proceedings started by creditors.

Co-ownership of real estate rights

Condominium

Considering that a subjective right may belong to different persons who are – all of them – co-holders of the same right, with reference to real estate, the most complex form of co-ownership is represented by the condominium in buildings.

In particular, the peculiarity of the condominium is represented by the circumstance that each owner of an apartment has, not only the exclusive and complete ownership of the mentioned apartment, but, additionally, the co-ownership of some parts of the building that are common property among the owners of the different floors or part of floors of the structure.

Mortgage

Mortgage is a typical right of lien, which may be created on real estate property and on real estate enjoyment rights.

The mortgage gives the creditor a right to expropriate the property made available to secure his/her claim, even against a third-person transferee, and a preference in being paid from the proceeds of the expropriation.

In any case, the owner remains the person who has the faculty to enjoy the property.

A mortgage should be imposed on the debtor's property and it is established by means of the inscription in the immovable property registers of the place where it is located.

The mortgage is effective for a period of 20 years from its inscription date.

The effects of the inscription cease unless it is renewed before the expiration of the mentioned time limit.

Therefore, before executing any legal documents, agreements and deeds involving Italian real estate property, the relevant public registers should always be thoroughly searched and verified to ascertain the absence of mortgages on the property.

A real estate property may be subject to further prejudicial inscriptions (ie, seizure of attachment of property, etc). Considering that the inscriptions are recorded in the Land Registry, it is advisable to investigate their potential occurrence prior to the execution of any agreement relating to the property and, in particular, the deed of transfer.

Tax aspects

Income tax – Qualification of income

In principle, real estate properties registered (or which should be registered) in the Cadastral Registry are deemed to produce a taxable income (ie, cadastral income), even if not used by the owner or even if not leased to third parties. This income is generally subject to taxation in the hands of the owner of the real estate, in property or in virtue of another real right (eg, usufruct, use, habitation, emphyteusis, etc). The taxation of this income varies according to its tax qualification, nature and tax status of the owner, characteristics and destination of the real estate property.

Income taxation of individuals

In Italy, individuals are subject to personal income tax (*imposta sul reddito delle persone fisiche*, or IRPEF).

Resident individuals

Italian resident individuals are subject to IRPEF (and to local surcharges) on their worldwide income. IRPEF is calculated through gradual rates by brackets of income, which presently range from 23% up to 43%. The highest rate applies on the amount of the aggregate taxable income exceeding 75,000 EUR. In addition to IRPEF, a regional surcharge, with rate ranging from 0.7% to 3.33%, and a municipal surcharge, with rate up to 0.9%, have to be paid.

For income tax purposes, an individual is considered to be a resident of Italy if for the most part of the year (ie, 183 days or more) she/he is registered in the resident population registers, or has his/her domicile or residence in the Italian territory (pursuant to the Italian Civil Code and therefore, respectively: where the main place of affaires and interests is established and where there is the usual abode).

As far as real estate income is concerned, resident individuals are subject to income tax for the income (not collected in the context of a business activity carried out) deriving from their real estate properties, even if located outside the Italian territory (with some exclusions).

With regard to real estate properties not leased to third parties, generally the local property tax (ie, IMU – see below) replaces IRPEF and local surcharges with regard to the income deriving from such properties. Therefore, in this case, only IMU falls due.

This rule does not apply to vacant residential properties located in the Municipality of the taxpayer's residence. For such buildings, 50% of the cadastral income, revaluated by 5%, increased by one-third and adjusted in consideration of the owning period incurred in the tax period, is subject to IRPEF.

Where the real estate properties are leased out to third parties, the taxable income for income tax generally corresponds to the highest amount between: (i) the cadastral income revaluated by 5% and adjusted according to the owning period; and (ii) the rentals accrued in the relevant tax period according to the lease agreements. For this purpose, rentals benefit from a 5% flat reduction, in consideration of any management and maintenance expenses incurred by the owner, regardless of whether such expenses have been actually suffered or not. As a result, related expenses actually incurred are not relevant for tax purposes.

For the lease of buildings for housing purposes, an alternative (and more favourable) tax regime is available. Such tax regime, so-called "*cedolare secca*" and applicable upon option of the lessor, provides for the application of a substitute tax, which replaces income taxes (IRPEF and local surcharges), registration tax and stamp duty on the lease agreement. The substitute tax applies at the rate of 21% (10% in particular circumstances) on the gross annual rental (no costs deduction is allowed). Various conditions should be met in order to opt for the "*cedolare secca*" regime, and in particular:

- the lease agreement should not be concluded within the framework of a business, art or profession by both the lessor and the lessee, if any;
- the real estate should be classified as housing residence in the Cadastral Registry and should be effectively used in this way (appurtenances also can benefit from this regime).

Non-resident individuals

Foreign individuals are considered non-resident in Italy for tax purposes if they have no domicile or residence in the Italian territory for the most part of the year.

However, they may be subject to tax in Italy (at the same rates provided for Italian residents) in respect of income deemed to be sourced inside the Italian territory, such as the case of income deriving from real estate properties located therein.

In this respect, the tax rules provided for Italian residents apply also to non-residents.

Income taxation of corporate entities

From an income tax perspective, entities other than individuals have to be divided into the following categories, which generally apply different income tax regimes:

- resident partnerships (including also other resident associations without legal personality and assimilated entities);
- resident companies (including companies limited by shares and limited liability companies);
- resident commercial entities (carrying on business activities as sole or prevalent purpose);
- resident non-commercial entities (not carrying on business activities as sole or prevalent purpose);
- foreign companies and entities of any kind (with or without legal personality) with permanent establishment (PE) in the Italian territory (it has to be considered that, unless the contrary is proven, foreign companies controlling Italian companies or commercial entities are deemed to be Italian tax-resident if, alternatively, they are controlled by Italian resident subjects or are administrated by a body predominantly composed of Italian resident individuals);
- foreign companies and entities of any kind without PE in the Italian territory.

The above entities, excluding the resident partnerships that are tax transparent (except for IRAP) and whose income is taxed directly in the hands of the partners proportionally to their participation, are subject to IRES and IRAP (except for resident non-commercial entities and foreign entities without Italian PE).

Tax rules concerning the determination of the taxable real estate income apply almost similarly to both partnerships and assimilated entities, as well as to companies and other commercial entities. Hereinafter, reference is made mainly to resident companies (ie, companies limited by shares, S.p.A., and limited liability companies, S.r.l., to which PEs of foreign companies are assimilated for tax purposes), which are the most commonly used vehicles for real estate investments.

Resident companies

Corporate income tax (IRES)
Resident companies (ie, companies which have legal seat, place of effective management, or main business object in Italy for the most part of the tax period) are subject to IRES, levied at the rate of 24% (from 2017).

The taxable business income is computed by adding to the net civil result of the profit and loss (P&L) account of each tax period, any increasing or decreasing adjustment provided for by the business income tax rules.

Pursuant to the "worldwide principle" on which the Italian tax system is based, as for resident individuals, the taxable income of resident corporate entities includes their worldwide income, ie, the income also sourced outside the Italian territory (except that for which the foreign branch exemption option is elected) tax credit in Italy for income taxes paid abroad is provided).

Income from lands and "instrumental" buildings (ie, buildings directly used solely to perform the business activity and buildings whose destination cannot be changed without a complete transformation – ie, commercial or industrial buildings, offices, etc – even if not directly used or leased to third parties) are generally determined according to the tax rules applicable to business income, that's in general revenues less pertaining costs.

The income deriving from "non-instrumental" buildings (ie, residential buildings not directly used solely for the purpose of the business activity carried out and not representing available stock) forms part of the taxable business income as follows:

- for not leased buildings, the cadastral income (ie, deemed income assigned by the Cadaster), revaluated by 5% and adjusted in consideration of the owning period incurred in the tax period, increased by one-third;
- for leased buildings, the highest amount between: (i) the cadastral income, revaluated by 5% and adjusted according to the owning period; and (ii) the rentals referring to the relevant tax period according to the lease agreements, reduced by a maximum 15% amount of the rentals for certain maintenance expenses actually incurred (expenses exceeding 15% of rentals are not deductible from income tax).

Therefore, expenses and other items concerning "non-instrumental" buildings are generally not deductible with exclusion of interest expenses on financing for the acquisition of the buildings.

In the case of instrumental buildings, the local property tax (IMU) paid is 60% deductible for FYs 2020 and 2021; it will be fully deductible from FY 2022 onwards.

The IRES taxable base can be reduced through deduction of 10% of the IRAP paid out during the year, in the case the company has interest expenses and labour costs which are IRAP not deductible, and through the deduction of IRAP referable to the non-deductible portion of labour costs (ie, net of allowances deductions).

The Allowance for Corporate Equity (*aiuto alla crescita economica*, or ACE) is another tax relief which allows an additional deduction for IRES purposes, corresponding to the notional return on capital net increase (ie, notional interest deduction, or NID). This notional return is computed in each tax period on the aggregated net increase of net equity occurring after fiscal year 2010 (ie, ACE basis) at the 1.3% rate. The notional amount exceeding the taxable income of a year can be carried forward to increase the amount deductible from the taxable income of the following tax periods. Alternatively, the unused ACE deduction can be converted into a tax credit to offset (exclusively) IRAP liabilities.

Thin capitalisation rule
For IRES purposes interests and similar expenses (ie, the interest derived from loans, financial leasing contracts, bonds and any other contract of a financial nature, including interest expenses capitalised), are deductible in each tax period up to the amount of interest receivables and similar revenues; any excess is deductible up to 30% of the "rectified"/tax EBITDA (ie, determined excluding, from the accounting EBITDA, costs and revenues which are not tax relevant; specific rules are provided to handle the switch from accounting to tax EBITDA).

Interest expenses exceeding the 30% "rectified"/tax EBITDA can be carried forward indefinitely in the following tax periods. Therefore, non-deducted interest expenses can be deducted in future years if, and to the extent, the interest expenses of such years do not exceed the interest receivables and the 30% EBITDA of the same years.

Also, any excesses of 30% "rectified"/tax EBITDA (ie, the amount exceeding the net interest expenses of the same fiscal year) and interest receivables can be carried forward and used to increase the respective items of the following fiscal years. However, while interest receivables excesses can be carried forward indefinitely, the carry forward of the excess of 30% EBITDA is limited to five tax periods. In terms of utilisation order, after the 30% EBITDA of the year, the oldest excess has to be used as first (ie, FIFO method).

It is worth noting that, in the case of intercompany non-interest bearing loans, the notional interest cost booked in the profit and loss account according to the so-called amortized cost method, as provided by the applicable accounting standards, is however not relevant for tax purpose (ie, it is not deductible for IRES purposes). At the

same way, the equity reserve booked pursuant to the applicable accounting principles, is not relevant for ACE (NID) purposes.

This interest deductibility limitation does not apply to, among others, interest expense on facilities guaranteed with mortgage on properties addressed to the lease business. In this respect, by way of law rewording effective from 2016, the exclusion of mortgage loans interest from the EBITDA limitation is applicable only to companies which "actually" and "prevalently" carry on real estate activity and this is met if the following conditions are fulfilled:

- the total assets are mainly constituted by properties to be leased (evaluated at fair market value);
- at least 2/3 of the revenues derive from the related rental activity.

This kind of exception is not contemplated by the Anti-Tax Avoidance Directive (ATAD), EU 1164/2016. Indeed, the law implementing ATAD in the Italian income tax system had repealed such provision. Nevertheless, the Financial Budget Law for year 2019 has rectified this provision of the ATAD implementing law, with the effect that the above exception is currently still applicable.

Mitigation of the interest expenses non-deductibility is possible under the domestic tax group regime, if and to the extent that companies participating to the tax group have unused EBITDA or interest income excesses (accrued during the regime) against which the excesses of interest expense of other participating companies (also accrued during the regime) may be deducted.

This interest deductibility limitation applies also to "industrial holding companies" (ie, in general, companies with the majority of balance-sheet assets related to stakes in non-banking/non-financial entities).

Since this provision regulates interest expense deduction for IRES purposes, it does not apply to partnerships (which are transparent for income tax purpose).

Depreciation
As a general rule, land cannot be depreciated. Therefore, in order to determine tax-deductible depreciation, the cost of instrumental buildings has to be considered net of the cost of the areas (land) on which such buildings are built/located and/or of those areas representing their pertinences. The cost of such areas, if not autonomously bought, is quantified as the greater of: (i) the balance-sheet value of the year of purchase (if any); and (ii) 20% of the total buildings' cost, increased to 30% for industrial buildings (defined as those used for the production and transformation of goods).

This land depreciation non-deductibility regime applies also to instrumental buildings owned under financial leasing contracts, with regard to the amount of the periodical rentals corresponding to the value of the lands on which the leased buildings are built/located or representing their pertinences.

With regard to instrumental buildings, the maximum depreciation rate for IRES purpose is 3% (reduced to one-half – ie, 1.5% – for the first year). This is applied to the purchase cost, increased by some ancillary expenses incurred for the property purchase (eg, eventual indirect taxes, notary's fee, intermediation fee, etc), certain interest costs, extraordinary maintenance and other capitalised costs, tax-relevant step-ups, etc. For shopping centres, an annual depreciation rate of 6% may be applicable.

Tax losses carryforward
For IRES, tax loss carryforward is admitted. Conversely, the IRAP system does not allow the tax loss carryforward.

IRES tax losses can be carried forward without any time limit to offset a positive IRES taxable base. More precisely, tax losses incurred in the first three periods of activity (provided that such losses refer to a new business activity) can be used to entirely offset positive IRES taxable bases without any limit. Instead, tax losses incurred in subsequent years can be used to offset up to 80% of a positive IRES taxable base of any given year. The remaining 20% of the positive taxable base must be taxed at the ordinary IRES rate, if the tax losses of the first three years are not available.

The loss carryforward is forbidden in the case of transfer of shares representing the majority of voting rights in the company's general meetings, together with a change of the business activity from which the loss derived (see also section "*Decrease of capital*").

Non-operating companies regulation
Real estate companies have to take into consideration the "non-operating companies' regulation" (or "dummy companies' legislation").

A company is deemed to be non-operating if its average actual proceeds over the last three years (excluding the extraordinary ones) are lower than its expected proceeds. The latter are calculated by applying certain coefficients to the average value over the last three years of determined categories of assets (ie, (i) financial stakes, securities and financial credits; (ii) buildings and certain other registered assets; (iii) other tangible and intangible assets). For these categories of assets, the currently used coefficients (which signify the minimum profitability assumed for each category of assets) are, respectively, the following: 2%, 6% (reductions are provided in particular circumstances) and 15%.

In the event that the company is deemed non-operating, and any of the causes of exclusion provided do not apply, the main consequences are the following:

- computation of minimum taxable base for income taxes purposes (both IRES and IRAP) by applying stated coefficients on the value for the year of the three above-mentioned asset categories (respectively: 1.5%, 4.75%, 12%, but reduced rates are provided in particular circumstances), regardless of the actual P&L account result for the year (as far as the minimum IRAP taxable base is concerned, some further rules have to be taken into consideration). ACE deduction carried forward can be used to reduce the minimum IRES taxable base. On the contrary, tax losses of previous years cannot be used to reduce the minimum IRES taxable base;
- irrelevance of tax losses occurred in the years when the entity is deemed to be non-operative;
- limitations in recovering the VAT credit resulting from the annual VAT return.

The non-operating companies regulation is automatically inapplicable in specific cases provided by law (just for example: subjects which, due to the business performed, are obliged by law to be incorporated in the form of joint-stock company; subjects that are in the first tax period, subjects controlling listed companies or entities, or being themselves listed, or directly or indirectly controlled by listed companies or entities, etc). The tax authorities can identify further cases of exclusion.

Furthermore, a real estate company may be deemed non-operating, regardless if its actual proceeds are higher than the expected ones, if the same is in a “systematic tax loss” position. Such condition is verified if the company generated tax losses for five consecutive tax periods (as resulting from its tax returns), or if in the same five-year period it generates tax losses for four years and for the remaining year it earned proceeds lower than the expected ones. Also, in this case, some causes of exclusion may apply.

If none of the “automatic” cases of exclusion can be invoked, the non-application of the “non-operating” and “systematic tax loss” companies regulations may be claimed by ruling, describing and documenting objective circumstances and situations which caused the non-operating status or the systematic tax loss position. The ruling can be submitted by the taxpayer within the deadline for the filing of the relevant tax return (ie, the tax return regarding the tax period interested by the discipline). The ruling is then decided by the tax authorities within 120 days on a case-by-case basis, considering motivations pointed out by taxpayers.

As of 2016, this kind of ruling has become a faculty. Therefore, the taxpayer which considers as not due to its will or discretionary the facts and circumstances which did not consent the minimum level of revenues and does not want to submit the ruling, can settle income taxes and fulfil relevant payment and reporting obligations without considering the non-operating companies rules. The proper demonstration and related documentation have to be submitted to the Tax Office upon request.

Regional tax on production (IRAP)
Business activities (with some exceptions) are subject to the regional tax on production (*imposta regionale sulle attività produttive*, or IRAP). This tax is levied on the net value of the production deriving from the business activity carried out.

The ordinary tax rate is 3.9%. Each Italian region may increase or decrease up to 0.92% the ordinary IRAP rate (also applying different rates according to the business activity performed). In addition, the IRAP rate is increased (eg, by further 0.15%) in those regions that have the health service system in deficit.

The IRAP taxable base is different from the IRES one and it varies according to the kind of business activity carried out.

For entities performing industrial/commercial activities (including real estate property/management companies), other than banking and financial businesses, the IRAP taxable base is the result of the following calculation:

+ gross proceeds from sales and services

+/- variations in inventory and work in progress

+ other non-financial incomes

- cost of raw and other materials

- cost of services (administrative costs)

- depreciation of tangible and intangible assets

- other operating expenses

= value of production.

The value of production also includes gains/losses deriving from disposal of real estate properties (even if non-instrumental or not directly used only for business purposes, and not representing stock inventory), unless the

disposal intervenes in the context of a business or ongoing concern transfer which generates income not subject to IRAP.

Interest expenses (also those implicitly included in financial leasing rentals) and income are not included in the IRAP taxable base (in practice, they are, respectively, not deductible and not taxable). An exception is represented by the so-called industrial holding companies (ie, in general, companies with the majority of balance-sheet assets related to stakes in non-banking/non-financial entities): for these companies interest income and expenses (the latest up to 96%) form part of the IRAP taxable base.

Provisions for bad debt and devaluation on assets and on receivables do not have to be considered in computing the IRAP taxable base.

Labour costs are partially deductible, except labour costs concerning open-ended jobs that, from 2015, are fully deductible.

The local property tax (IMU) is not deductible.

Non-resident entities (ie, individuals or corporate bodies) are subject to IRAP only when they perform commercial activities in Italy for at least three months through a PE or fixed place of business.

Non-resident companies

Non-resident entities (ie, entities that do not have legal seat, place of effective management, or main business object in Italy for the most part of the tax period), without a PE within the Italian territory, are subject to taxation in Italy only for income deemed to be produced therein. In this case, non-resident entities are subject to IRES, levied at the rate of 24%, with exclusion of tax-exempt income and income subject either to a definitive withholding tax (WHT) at source or to a substitute tax.

The taxable income, if any, shall be determined in accordance with the rules provided for the tax category to which the taxable income pertains.

As far as income deriving from real estate properties located in Italy is concerned, the taxable income is determined as follows:

- For properties not leased to third parties, the taxable income is the cadastral income, revaluated by 5% and adjusted in consideration of the owning period incurred in the tax period, increased by one-third for residential buildings.
- For leased properties, the highest amount between: (i) the cadastral income, revaluated and adjusted as above and (ii) 95% of the rentals relating to the relevant tax period according to the lease agreements. In fact, for leased buildings the law admits a 5% flat reduction of rentals (a higher flat reduction is provided in some specific cases), in consideration of eventual management and maintenance expenses incurred by the owner. The flat reduction is recognised, regardless of whether expenses have been actually suffered or not. As a result, related expenses actually incurred are not relevant for tax purposes.

Indirect taxes

Value-added tax (VAT)

Transfer of property

The transfer of a real estate property represents “transfer of goods” for VAT purposes (unless it is included in an on-going business concern) and it falls in the scope of Italian VAT (with the exception of non-buildable lands, never subject to VAT) if: i) the real estate property is located in Italy; ii) the vendor is a business undertaker or a professional taxpayer and; iii) the real estate is included among the assets concerning the business or professional activity carried out.

The Italian VAT system provides a general VAT-exemption regime to real estate transfers and leases, with some exceptions. In this respect, once a real estate transaction falls in the scope of VAT, it has to be determined if it is subject to proportional tax or if the general VAT-exemption regime applies.

As far as lands are concerned, transfers of agricultural lands/non-buildable lands are always out of the scope of VAT. Transfers of other kinds of land are subject to proportional VAT.

With reference to buildings, different rules are provided for:

- buildings for housing purpose (ie, residential) and
- instrumental buildings (commercial or industrial buildings, offices, hotels, warehouses, etc).

Transfers of buildings for housing purposes are VAT-exempt, with the following exceptions:

- Transfers executed by subjects that have performed construction or restructuring works, even in outsourcing, within five years from the end of such works.
- After five years, upon builder's/restructurer's option to apply VAT (to be expressed in the transfer deed).

In these two cases, VAT applies ordinarily. However, in the case of seller's VAT option, the tax is applied by the buyer (if it qualifies as a VAT entity) according to the reverse charge mechanism.

Transfers of instrumental buildings are VAT-exempt, with the following exceptions:

- transfers executed by subjects that have performed construction or restructuring works, even in outsourcing, within five years from the end of such works;
- upon seller's option (to be expressed in the transfer deed).

In the case of seller's VAT option, the tax is applied by the buyer (if it qualifies as a VAT entity) according to the reverse charge mechanism.

It is important to note that the execution of VAT-exempt operations generally reduces the recoverability of input VAT on purchases, since these transactions affect the VAT recoverability pro rata ratio.

Transfers of buildings under construction or restructuring/refurbishment, with works actually and substantially started and still in course at the time of the transfer, should normally be subject to VAT by the seller.

For real estate transfers subject to VAT, the tax generally applies with the following rates:

- 22% ordinary rate;
- 4% and 10%, soft rates, applicable in particular cases (eg, residential buildings having certain requirements; refurbished buildings sold by refurbisher).

With regard to the territoriality requirement for real estate-connected services and operations, effective from 1 January 2017, a new EU Regulation sets out new and more precise criteria to assess their connection with the real estate, thus becoming VATable in the territory where the real estate is located.

Lease of property
The lease (including financial leasing) of real estate property falls in the scope of VAT when it is carried out by a company, or another VAT entity, since it is treated as supply of services. The VAT regime applicable to lease contracts concerning real estate properties, provides for a general VAT-exemption regime, with some exceptions.

As far as lands are concerned, the lease of agricultural lands (other than those used as parking), when executed by VAT entities, falls in the scope of VAT as VAT-exempt transaction. The lease of parking areas and buildable lands is, instead, subject to proportional VAT.

With reference to buildings, there are different rules for:

- buildings for housing purposes; and
- instrumental buildings (as already defined above).

Lease contracts concerning buildings for housing purposes are generally VAT-exempt, apart from leases made by builders or subjects that have performed building restructuring works which can be subject to VAT upon option to be expressed in the contract.

Lease contracts concerning instrumental buildings are VAT-exempt, apart from the case of lessor's VAT option to be expressed in the contract.

It is important to note that the execution of VAT-exempt operations generally reduces the recoverability of input VAT on purchases, since these transactions affect the VAT recoverability pro rata ratio.

For transactions subject to VAT, the applicable rate is generally 22%. Different/reduced rates are provided in specific cases.

Registration tax

Transfer of property
The transfer of real estate properties is subject to registration tax, which may fall due in fixed or proportional amount.

In general, according to the principle of alternation between registration tax and VAT, for transactions subject to VAT (even under the VAT-exemption regime, but some exceptions are provided) registration tax is generally due at a fixed amount. Conversely, transactions out of the VAT scope are subject to proportional registration tax, with different rates according to the transaction's object and the parties involved.

As far as the real estate industry is concerned, some exceptions to the general principle of alternation are provided. As a result, the following rules generally apply.

Transfers of buildings for housing purposes are subject to registration tax at the fixed amount of 200 EUR if they are subject to proportional VAT.

For transfers of buildings for housing purposes VAT-exempt or out of VAT scope (such as, eg, transfers performed by non-VAT entities), registration tax falls due in proportional amount (with a minimum amount of 1.000 EUR). The rates generally applied are the following:

- 2% if the purchaser is a private individual using the building as his/her main residence ("first home").
- 9% in the other cases.

For transfers of instrumental buildings performed by VAT-entities, registration tax is due in the fixed amount of 200 EUR, regardless of whether they are subject to VAT or VAT-exempt.

The registration tax rate for transfers of agricultural lands in favour of subjects different from farmers is 15% (fixed nominal amount for transfers to farmers). With reference to the transfer of buildable lands, registration tax is generally due, if the seller is not a VAT subject, at the proportional rate of 9%. If the land should not be qualified neither as agricultural nor as buildable land at the time of transfer (ie, parking area), it should be subject to proportional registration at the rate of 9%, even if the seller is a VAT subject.

The taxable base is the commercial value of the real estate property at the date of the transfer (an alternative applies to individuals – see below). The commercial value is the exchange value inferable from the market. As a consequence, the tax authorities can amend the value declared by the parties should it be lower than the commercial value.

In the case of residential building transfers, individuals may opt for the so-called "*prezzo-valore*" mechanism (ie, the taxable value is the cadastral value of the building, determined by multiplying the cadastral income by specific revaluation coefficients that vary according to the cadastral category of the building). In this case, the tax authorities' assessment capacity is excluded.

Seller and buyer are jointly and severally liable for the payment of registration tax. Commercially, it is generally suffered by the buyer.

Lease of property

Lease contracts concerning real estate properties, stipulated in Italy and lasting more than 30 days, should be registered within 30 days from their execution and are generally subject to registration tax, regardless of whether or not the rentals are subject to VAT. Registration tax also applies to financial leasing contracts.

Lease agreements with duration higher than nine years are also subject to fixed nominal mortgage tax (200 EUR). For the lease of buildings for housing purposes, registration tax is due annually at the rate of 2%, applied on contractual rentals pertaining to the relevant year. The rate is reduced to 1% for the lease of instrumental buildings, also in the case the rental is subject to VAT.

As far as long leases are concerned, registration tax may be paid in a sole instalment, upon contract registration, for the entire tenancy term, benefiting from a tax discount calculated based on the legal interest rate.

In the case of lease of buildings for housing purpose made by individuals, the substitute tax regime (so-called "*cedolare secca*") provided for the lessor for income tax purposes, replaces also registration tax on rentals (see section "*Income taxation of individuals*").

With reference to lands, the lease of agricultural lands is generally subject to 0.5% registration tax; the lease of other kinds of land is subject to 2% registration tax if leased by a non-VAT subject, or to a fixed amount of 67 EUR if leased by a VAT entity (so subject to VAT).

For financial leasing contracts, normally subject to VAT, starting from 1 January 2011:

- For contracts drawn up by public deed or by authenticated/notarised private deed, registration tax is due in fixed amount of 200 EUR (as consequence of the alternation VAT-registration tax).
- For contracts drawn up by private deed (non-notarised), registration tax is due (in fixed amount of 200 EUR) only in the case of voluntary registration, or "*caso d'uso*" (ie, filing, not required by the law, of the deed for the purpose of administrative activities/proceedings), or if it is mentioned in another document between the same parties which is subject to registration.

According to these rules, the other indirect taxes (ie, mortgage and cadastral taxes – see below) apply in proportional amount upon the purchase of the leased building made by the financial leasing company; the same apply in fixed amount on the asset purchase made by the lessee upon redemption or expiration of the financial leasing contract (see also section "*Managing property in Italy*").

Cadastral and mortgage taxes

The transfer of real estate properties is subject to specific formalities accomplished by special public offices that keep and preserve public real estate registers.

Each deed implying the transfer of real estate properties must be registered in these registers. These registrations are subject to cadastral and mortgage taxes at the following rates:

- mortgage tax: 2%, increased to 3% for instrumental buildings;
- cadastral tax: 1%.

Generally, the taxable base of these taxes is the same used for registration tax purposes.

Cadastral and mortgage taxes apply at the fixed amount of 50 EUR each if the transfer concerns a residential building subject to 9% registration tax.

As well, cadastral and mortgage taxes are due in fixed amount of 200 EUR each for transfers of buildings for housing purposes subject to proportional VAT.

For transfers of instrumental buildings performed by VAT-entities, cadastral and mortgage taxes are due in the proportional amount of 3% and 1%, regardless of whether they are subject to VAT or VAT-exempt.

For transfers of instrumental buildings performed by non VAT-entities, cadastral and mortgage taxes are due in the fixed amount of 50 EUR each.

Mortgage and cadastral taxes are generally suffered by the purchaser of the real estate (pursuant to contractual arrangements). However, as for registration tax, purchaser and seller are both jointly and severally liable for these taxes vis-à-vis the tax authorities.

Inheritance and gift taxes

Inheritance tax and gift tax affect free transfers and transfers due to death (*mortis causa*).

The gift tax applies also to assets tied up for a specific purpose (*vincolo di destinazione*) and for assets assigned to a trust. As regard the specific case of trusts, the concrete taxation applicable shall be evaluated on a case-by-case basis.

For inheritance tax and gift tax purposes, the same rates apply.

The applicable tax rates vary according to the specific relationship between the transferor subject (ie, the "*de cuius*" in the case of inheritance; the donor in the case of a gift) and the transferee subject (ie, the heir for inheritance; the donee for a gift), regardless of the nature of the transferred assets.

In particular, the following rules apply:

- Transfers in favour of the spouse and relatives in direct line are subject to 4% tax, with an exempt amount of 1 million EUR (ie, the tax applies on the exceeding amount).
- Transfers in favour of brothers and sisters are subject to 6% tax, with an exempt amount of 100,000 EUR (ie, the tax applies on the exceeding amount).
- Transfers in favour of other relatives until the fourth degree and relative-in-law in direct and collateral line until the third degree are subject to 6% tax (with no exemption).
- Other transfers are subject to 8% tax (with no exemption).

If the transferred object is a real estate property, proportional mortgage and cadastral taxes may be due. However, in the case of buildings for housing purposes, these taxes may be applied in a fixed amount (200 EUR each) to the extent that the beneficiary subject (ie, heir or assignee) is entitled to apply the tax relief provided for the purchase of the "first home".

Local property taxes

Municipal property tax (IMU)

Real estate properties (ie, buildings, building lands) are generally subject to municipal property tax (IMU) which is levied on the owner of the property right or on the holder of other real estate rights, in proportion to the months of effective possession. The month with possession shorter than 15 days is not computed; if longer the month is fully accounted.

IMU is computed in different ways, depending on the characteristics and location of the properties.

With reference to buildings, the taxable base for each cadastral unit is generally its "cadastral value", determined on the basis of its cadastral deemed income, increased by 5% and multiplied by specific coefficients. For "artistic and historical" buildings the taxable base is reduced by 50%.

For buildable lands, the taxable base is generally the "commercial value" (ie, fair market value) of the land at the beginning of the relevant year.

For agricultural lands, the taxable base is computed on cadastral deemed income (*reddito dominicale*) increased by 25% and multiplied for 135.

Tax exemptions/reductions are provided for building constructed by the builder and not yet sold by the same, for unfit-for-use buildings and other limited circumstances. From FY 2022 onwards, these kinds of buildings will be IMU-exempted.

The IMU tax rates are determined by the competent municipality, within the limits stated by the law, and may vary on the characteristics of the properties and on the status of the owner. The standard IMU rate is 0.86% (increased from the previous rate of 0.76% as, effective from FY 2020, IMU has absorbed the municipal tax for indivisible services, or TASI), excluding residential properties held by individuals as their main home which are generally IMU-exempted. However, municipalities may increase the standard rate up to 1.06% (1.14% under specified circumstances).

IMU is not deductible for the purpose of IRPEF, while for corporate entities, in the case of instrumental buildings, it is 60% deductible for IRES purpose for FYs 2020 and 2021 and fully deductible from FY 2022 onwards. Conversely, IMU is not deductible for IRAP purpose.

Municipal waste tax (TARI)
TARI is due entirely by the user of a real estate property (owner or, where there is a lease contract, the tenant).

It is calculated on the basis of tariffs established by the Municipality (which depend on the floor area of the building and on the business activity carried on). Generally, the computation is made directly by the Municipality and provided to the taxpayer for relevant payment.

Buying real estate property through an Italian company

Legal aspects

Notwithstanding the possibility to purchase a real estate property by means of a direct investment, foreign investors also have the opportunity to benefit from greater flexibility and protection when structuring investments in Italian companies.

Tax aspects

An alternative to the direct acquisition of real estate properties may be the purchase of interest in companies owning such properties. From the investors' perspective, this route has specific features, different from those associated with the direct investment in real estate.

In general, the investment through a real estate company generates income having a financial nature: dividends from net profit distributions and capital gains from shareholding disposals.

Income taxation of individuals

Resident individuals

Dividends collected by resident individuals are subject to a 26% definitive WHT/substitute tax.

Until the end of 2017, the 26% levy was applicable if the participation in the dividend-distributing company did not exceed 2% of the voting rights or 5% of the capital in the case of listed company and 20% of the voting rights or 25% of the capital in the case of not listed company, tested on a twelve-month basis ("non-qualified participation"); conversely, if the participation exceeded these thresholds ("qualified participation"), a portion of the dividend collected (due to a dividend exemption regime) was subject to individual income tax according to the ordinary rules, and no WHT had to be levied. However, this former regime will temporarily apply to dividend distributions resolved until 31 December 2022 and executed out from profits earned until the tax period 2017.

Where dividends refer to participations held in relation to business activities performed, they form part of the business income for 49.72% of the same (thereby exempt at 50.28%) and are taxed accordingly.

Capital gains realised by resident individuals on disposal of participations into companies, partnerships and other bodies, are subject to a substitute tax at the rate of 26%. Capital losses can reduce the taxable base, under terms and limits stated by the law.

Until the end of 2018, the 26% substitute tax applied only to capital gains from disposal of non-qualified participations. Conversely, capital gains realised on disposal of qualified participations were subject to ordinary IRPEF on 49.72% (therefore exempt at 50.28%) of their amount, net of 49.72% of capital losses having the same nature.

Capital gains referring to participations held in relation to business activities carried out, form part of the taxable business income. In this context, under the participation exemption regime, the capital gain may be 50.28% exempt from taxation, provided that subjective and objective requirements are met; in this case, only 49.72% of the capital gain is taxable. It should be noted that the participation exemption is not applicable to participations in real estate companies, with the exception of real estate building developing/trading companies.

Non-resident individuals

Dividends deriving from ordinary shares or quotas collected by non-resident individuals are subject to a 26% domestic WHT, levied at source as definitive payment. However, according to domestic rules, non-resident subjects can claim a refund for part of the Italian WHT suffered, for the amount of taxes they have paid abroad on the same income, up to eleven twenty-sixths (11/26ths) of such Italian WHT (ie, maximum 11%). The payment of the foreign taxes has to be certified by the competent foreign tax authority. Reimbursement should not be provided for dividends collected on savings shares.

Furthermore, the Italian WHT may be reduced by means of application of bilateral treaties against double taxation entered into by Italy, if any, and provided that all requirements are met.

With reference to capital gains, the tax treatment provided for resident individuals applies also to non-resident individuals. In this respect, however, two specific exceptions are provided for non-residents; in particular, capital gains are not taxable in Italy in the following cases:

- if deriving from the sale, against consideration, of non-qualified participations (as defined in section "*Resident individuals*") in resident companies listed in regulated markets;
- if deriving from the sale, against consideration, of non-qualified participations in resident companies not listed in regulated markets, provided that the foreign subject is resident in countries which have entered with Italy agreements allowing the exchange of tax information;

In the other cases, the exemption in Italy may be obtained by application of bilateral treaties against double taxation and provided that all requirements are met.

Income taxation of corporate entities

Resident companies

For IRES purposes, as far as dividends are concerned, the dividend exemption regime applies; therefore, dividends collected are excluded from the taxable business income up to 95% of their amount. This regime is not applicable to: (i) foreign dividends sourced in countries not included in the so-called "White List" for which a positive ruling is not obtained; (ii) foreign-sourced dividends related to profits that have been already taxed according to the Controlled Foreign Companies' rules, which are fully exempt; (iii) dividends collected on shares held for trading by entities drawing up their financial statements in accordance with IAS/IFRS.

With reference to capital gains, if certain conditions are met, the corporate income tax rules provide a participation exemption regime for 95% of the gain realised on disposal of certain participations held as investment for at least 12 months. On the other hand, capital losses on same participations are not deductible. However, the participation exemption regime is generally not applicable to participations in real estate companies, with the exception of real estate building developing/trading companies.

If the participation exemption regime cannot be applied, capital gains are entirely included in the taxable business income of the tax period of realisation and taxed accordingly. However, if participations are held as fixed assets and booked as such over the last three financial statements, capital gain may be taxed in equal instalments in the tax period of realisation and in the following four years.

A specific anti-abuse provision (not applicable to entities drawing up the financial statement according to IAS/IFRS) is in force from 2006 to contrast the tax abusive utilization of the dividend exemption regime. In particular, capital losses on shares, quotas and financial instruments similar to shares, acquired in the 36 months prior to their disposal, not having the requirements to benefit from the participation exemption regime, are not deductible up to the non-taxed amount of dividends collected in the 36 months prior to the realisation of the capital loss.

For shares potentially falling in the scope of participation exemption (thus out of scope of the above mentioned anti-abuse rule), but held for less than 12 months, exempt dividends collected during the holding period reduce the purchase cost of the shares (therefore increasing the taxable capital gain or reducing the deductible capital loss).

As far as the IRAP is concerned, for commercial and industrial companies both dividends and capital gains deriving from participations are not subject to tax, being excluded from the IRAP taxable base (see also section "*Direct investment in Italian real estate property*").

Non-resident companies

For non-resident companies without a PE in Italy, Italian-sourced dividends are subject to the 26% domestic WHT, levied at source as definitive payment. However, according to domestic rules, non-resident entities can claim a refund for part of the Italian WHT suffered, for the amount of taxes they have paid abroad on the same income, up to eleven twenty-sixths (11/26ths) of such Italian WHT (ie, maximum 11%). The payment of the foreign taxes has to be certified by the competent foreign tax authority. Reimbursement should not be provided for dividends collected on savings shares.

The Italian WHT may be reduced pursuant to the application of the treaties against double taxation entered into by Italy, if any, and provided that all requirements are met, or set to zero according to the EU Parent-Subsidiary Directive (90/435/EEC), to the extent that all conditions are met.

For dividends paid out to corporations and other entities subject to income tax and resident in a Member State of the European Union (EU) or in a country belonging to the European Economic Area (EEA), the domestic WHT rate is 1.2% (1.375% until 2016).

Regarding the tax treatment of capital gains, rules outlined in respect of non-resident individuals also apply in the case of foreign companies (nevertheless, the applicable IRES rate is 24%).

Indirect taxes

Transfers of shares or quotas of Italian companies are VAT-exempt transactions (ie, falling in the scope of VAT, but without application of the tax, as per banking and financial operations) and are subject to registration tax at a fixed amount (200 EUR) if the transfer is executed through a public deed (ie, a deed drawn up by a public notary) or a private deed with authenticated signatures (ie, with only signature(s) authenticated by a public officer, generally a public notary). In the case of private deed, registration tax is due at a fixed amount (200 EUR), only in the case of voluntary registration, or "*caso d'uso*" (ie, filing, not required by the law, of the deed for the purpose of administrative activities/proceedings), or if it is mentioned in another document between the same parties which is subject to registration.

Furthermore, the transfer of shares (issued by Italian companies incorporated in the form of S.p.A.) is subject to financial transaction tax (FTT), equal to 0.2% of the purchase price of the shares.

Financing the indirect real estate property acquisition

Equity financing

Legal aspects concerning joint-stock companies/limited liability companies

The Italian Civil Code expressly provides the faculty to increase the share/quota capital through the issuing of new shares/quotas.

In this regard, the legal provisions set forth with reference to S.p.A. (joint-stock company) and S.r.l. (limited liability company) state that no corporate capital increase may take place until the shares/quotas previously issued are not completely paid up.

At the time of the subscription, the underwriters of newly issued shares/quotas are obliged to pay to the company at least 25% of the nominal value of the subscribed shares/quotas. In the event that a share/quota-premium is expressly provided, the premium itself must be paid in full at the time of subscription.

If the capital increase is subscribed by the sole quota holder, the contribution has to be completely paid up at the time of the subscription.

The increase of the share/quota capital may also take place by means of contributions in kind and of credits, provided that they are performed in compliance with the law.

Concerning the law provisions with reference to S.p.A., it is advisable to consider that the newly issued shares and bonds convertible into shares have to be offered, first, in option to the shareholders proportionally to the number of shares already owned by them.

No option right is given in the case of newly issued shares, which, according to the resolution for the share capital increase, must be paid by contributions in kind.

Tax aspects

A company's registered capital increase is subject to registration tax.

If it is made through the contribution of cash or assets other than immovable properties, registration tax is due in the fixed amount of 200 EUR.

Conversely, a company's registered capital increase made through contribution of immovable properties (ie, commercial/ housing buildings, lands, real enjoyment rights on immovable properties, etc) is subject to proportional registration tax, with rates ranging from 4% to 15% according to the nature of the contributed property.

Equity contributions in cash made without increasing the registered capital (ie, just aimed to set up capital/ equity reserves) are not subject to registration tax.

Debt financing

Legal aspects

The Italian Civil Code expressly provides, with reference to S.r.l., the quota holders' financing to the company, defined, for this purpose, as the financings that are granted at a time when - also taking into consideration the type of the business carried out - there is an excessive imbalance of the debt position compared to the net equity, or when the company's financial condition requires a capital contribution.

The purpose of the mentioned financings has to be found in the aim to provide the company - usually lowly capitalised companies characterised by a few number of members or family companies - with the instruments necessary for supporting the company activity, without the need to increase the corporate capital.

As for the S.p.A., it must be pointed out that the Italian Civil Code does not expressly regulate such an issue. In this regard, although the analogical application of the provision relating to S.r.l. also to S.p.A. is disputed, Italian authors appear in favour of its extension.

According to the resolution of the Interdepartmental Committee for Credit and Savings (CICR), issued on 3 March 1994, amended by the resolution of the same body, dated 19 July 2005, No 1058, shareholders are allowed to finance the company, only if expressly provided for in the memorandum of association and only when the members have been registered in the shareholders/quota holders' book for at least three months and hold a participation at least equal to 2% of the corporate capital.

Tax aspects

Indirect taxes

In general, loan agreements may fall in the scope of indirect taxes (ie, registration tax, mortgage tax, stamp duty). However, for loan agreements entered into by exchange of correspondence, indirect taxes are due only in the case of voluntary registration, or "*caso d'uso*" (ie, filing, not required by the law, of the deed for the purpose of administrative activities/proceedings), or if it is mentioned in another document between the same parties which is subject to registration.

Mortgage loans are subject to mortgage tax, with a rate of 2% for the mortgage raising, 1% for its renewal and 0.5% for its cancellation.

Medium/long term loans (ie, longer than 18 months) executed in Italy by Italian banks, Italian branches of foreign banks (EU/non-EU), EU banks (even without an Italian branch) can benefit, upon option expressed in the loan agreement, from a substitute tax of 0.25% of the amount of the loan. This option has been then extended also to the other financial intermediaries.

This tax replaces stamp duty, registration, mortgage taxes and other indirect taxes applicable to the loan and related agreements, including mortgages and other guarantees (which overall may also apply with higher rates: for example, mortgage tax is 2% of the amount guaranteed). In the case of mortgage loans, the substitute regime generally allows a material indirect tax saving.

The option to apply the substitute tax and the obligation to pay it to the tax authorities lies with the lender. However, it is common practice for banks to recharge the amount of the substitute tax to the borrower (by deduction from the loan principal).

Corporate income tax

As a general rule, interest payable on debt financing is deductible for IRES purposes, but not for the purpose of the IRAP (see sections "*Thin capitalisation rule*" and "*Regional tax on production (IRAP)*").

For financing operations performed with foreign-related parties, the interest rate shall comply with the "arm's length" principle.

Withholding tax on interest

In principle, interest paid to business operators is included in the taxable business income. If such interest is subject to WHT at source, the latest is generally levied as an advance payment of income tax (IRES or IRPEF).

On the contrary, the WHT represents a definitive taxation when interest is paid to individuals (and not related to a business activity eventually carried out) or to non-resident subjects. In this case, the subject collecting the interest has no further tax obligations to fulfil.

The WHT rate provided for interest is 26%.

For interest paid to non-resident subjects (other than those resident in the so-called "blacklist" countries, or tax havens), the above rate may be reduced or set to zero in accordance with the treaties against double taxation executed with Italy.

Moreover, according to the EU Interest-Royalties Directive (2003/49/EU) interest payments are not subject to the Italian WHT at source if certain conditions are met.

The exemption from Italian WHT at source also applies to interest (and royalties) paid to PEs, located in other EU Member States, of foreign EU companies meeting the above requirements.

Decrease of capital

Legal aspects concerning joint-stock companies/limited liability companies

The decrease of the share/quota capital can be effected on a voluntary basis either by releasing shareholders/quota holders from the duty of making payments still owing, or by reimbursing capital to the shareholders/quota holders. The reduction of the share/quota capital may also occur in the following cases:

- decrease of share/quota capital pursuant to losses; and
- decrease of share/quota capital below the legal minimum amount.

Managing property in Italy

Leases

Legal aspects

According to the relevant provision of the Italian Civil Code, the lease is an agreement by which one party binds itself to let the other party enjoy a movable or immovable good during a fixed period of time and for a defined consideration.

The lease agreements have to be divided into two categories:

(i) lease for private purpose (expressly provided by Law 392/78); and

(ii) lease for commercial purpose (provided by Law 392/78).

Both types of agreements are also regulated by the Italian Civil Code, which sets forth the general provisions concerning the lease contract.

Lease for private purpose

According to Law 431/98, the minimum term of lease agreement concerning immovable for private purpose cannot be lower than four years. The lease agreement is automatically renewed every four-year period, save for the cases in which the landlord intends to change the destination of use of the property.

At the expiry of the second term, each of the parties may decide to ask for the renewal of the agreement in accordance with new terms and conditions (T&C), or, alternatively, to renounce to such faculty, by means of sending a prior written notice to be sent, by registered letter, at least six months before the expiry of the term of the agreement.

In addition, Law 431/98 provides for two other types of lease agreements for private purposes:

- the agreed rent contract (*contratto di locazione a tariffa concordata o agevolata*), to be drawn up in compliance with the conditions and the criteria for quantification of the rent, as set forth by the associations of builders and tenants. The term of this type of agreement cannot be less than three years and renewable for two further years;
- agreement for temporary purposes (*contratto di locazione di natura transitoria*) which is a short-term rental with a minimum duration of one month up to a maximum of eighteen months. The agreement for temporary purposes is renewable, just once, up to eighteen months, provided that the transitory requirement persists, and it is confirmed by the parties prior to the agreement's expiration date.

Lease for commercial purpose

Lease agreements for commercial purpose are expressly regulated by Law 392/78.

Law 392/78 sets forth mandatory provisions which can be waived/derogated by the parties only in the case of commercial lease agreements concerning a property non having an historical interest according to Italian Law, with an annual rent higher than 250,000,00 EUR.

The main contractual clauses, suitable to be applied in compliance with Italian legislation, are the following:

Term
Not lower than six years (in the case if the destination of use is industrial, commercial, handcraft work, tourist interest) or nine years (in the case of rental for hotel use) and, in any case, not higher than 30 years.

Right of withdrawal
The parties have the faculty to allow contractually the possibility for the tenant to withdraw from the agreement, at any time, upon prior written notice to be sent to the landlord by means of registered letter, return receipt requested, at least six months before the date in which the withdrawal must be effective. Regardless of the contractual provisions agreed by the parties, should serious reasons occur, the tenant is entitled to withdraw from the agreement, at any time, upon prior written notice of six months to be sent to the landlord.

Renewal
According to section 28 of Law 392/78, lease agreement for commercial purposes is automatically renewed every six-year period, in the case if the destination of use is for industrial purposes, and every nine years in the case of hotel use, unless a prior written notice is sent by one party to the other party by means of registered letter, at least, respectively, 12 or 18 months before the expiry of the term of the agreement.

Denial of renewal
According to section 29 of Law 392/78, the landlord has the right to deny the renewal of the agreement at the expiry of the first term if one of the hypotheses listed in the above-mentioned section occurs. (By way of example and without limitation, in the case the landlord intends to: (i) modify the destination of use of the building, using the immovable as a private house; or (ii) destroy the building in order to rebuild or reconstruct it.) However, it is possible to provide in the lease agreement that the landlord waives to exercise the right set forth by section 29 after the expiry of the first term.

Adjustment of the rent
The parties may agree to yearly adjust the rent, upon request of the landlord, according to the variations of the Italian consumer price index published by the *Istituto Nazionale di Statistica* (ISTAT), for a maximum percentage of 75%. However, if agreed by the parties, the 100% of the variation of the ISTAT index may be applied to leases having a duration exceeding the minimum term provided for by Law 392/78 (ie, six years for commercial leases and nine years for hotel leases).

Maintenance
Generally, the ordinary maintenance of the building is performed by the tenant; the extraordinary one by the landlord.

Sublease
It is usually negotiated by the parties the possibility for the tenant to sublease the building, in full or in part, as well as to assign the rent agreement to third parties. The tenant, in any situation, is entitled to sublease the building, or to assign the relevant agreement, even without authorisation of the landlord, provided that it is jointly leased, or assigned the business, or the branch of business as a going concern.

Pre-emption right
According to section 38 of Law 392/78, in the case that the landlord intends to transfer the property of the building against payment, it must give to the tenant the possibility to exercise the pre-emption right set forth by the law. In particular, the landlord has to send a communication to the tenant containing the purchase price of the building, the selling T&C and the invitation to exercise the pre-emption right. The tenant has the faculty to exercise such right within 60 days from the receipt of the landlord's notice.

Redemption right
According to section 39 of Law 392/78, in the case that the landlord does not grant the tenant the right to exercise the pre-emption right or perform the transfer against a consideration lower than the one communicated to the tenant, the latter has the faculty to exercise the redemption right, within six months from the transcription of the deed of transfer.

Indemnity for loss of goodwill
In the case of termination of the lease agreement, not determined by the non-fulfilment or notice of withdrawal of the tenant, such party has the right to obtain an indemnity equal to 18 monthly instalments of the last rent paid. In the case of hotel use, the indemnity is equal to 21 monthly instalments.

Energetic certification
Legislative Decree No 28/2011 (published on the Official Gazette No 71/2011, entered into force on 28 March 2011), implementing the Directive 2009/28/EC of the European Parliament and of the Council dated 23 April 2009 on the promotion of the use of energy from renewal, has introduced several amendments to Legislative Decree No 192/2005. In particular, according to Legislative Decree No 28/2011, it is now mandatory to insert in the rental agreements of immovables (or individual property units), a clause by which the tenant shall acknowledge the receipt of the information and documentation regarding the energetic certification of the buildings; such provision applies only to the buildings or to the property units already provided by an energy performance certificate, pursuant to section 6(1) 1-bis, 1-ter and 1-quater of Legislative Decree No 192/2005.

Governmental measures adopted for addressing the impact of COVID-19 on commercial lease agreements

Decree Law No 18 of 17 March 2020 provides for:

- moratorium: payment of mortgages, leasing and loans instalments could be suspended until 30 September 2020 without additional charges, to the benefit of small and medium-sized companies (SMEs) suffering from liquidity problems due to the COVID-19 pandemic.

Decree Law No 23 of 8 April 2020:

- large companies, SMEs, entrepreneurs, professionals, or associations and companies between professionals, located in Italy and suffering the COVID-19 epidemic, may apply for loans secured by a public guarantee to be used for supporting lease rent or lease of business rents payment, personnel costs, investment activities, working capital expenditures aimed at sustaining the production facilities and the business activities located in Italy.
- rent payment for state-owned buildings used by companies under concession or lease agreement is suspended from 1 March 2020 to 31 July 2020. The rents will be paid by 31 October 2020 (available payment by instalments).

Finally, the Italian Government introduced further tenant relief measures:

- the access to loans or other financing measures also to small and medium-sized enterprises with up to 499 employees;
- special loans for real estate investment operations in the tourism and hotel sectors and in real estate activities, with a minimum duration of ten years and an amount higher than 500,000,00 EUR with the possibility of cumulation with other forms of guarantees, including mortgages.

Tax aspects

Income tax

See section "*Direct investment in Italian real estate property*".

Indirect taxes

See section "*Direct investment in Italian real estate property*".

Financial leasing contract

Legal aspects

The financial leasing agreement is a contract in force of which a party (lessor) grants another party the right to use an asset for a certain period of time, versus the payment of a rent. At the expiration of the lease, the lessee may choose to return the asset to the lessor, or to purchase it for an amount of money that has been established in advance.

Pursuant to Law No 124/2017 (published in the Official Gazette on 14 August 2017 and entered into force on 29 August 2017), the Italian legislator has introduced into the Italian legal system an express definition of the financial leasing agreement. Before the Law 124/2017 was introduced, although the lack of an acknowledgement by the Italian regulations of an autonomous identity to the leasing agreement, its development and wide use for many years has generated a lot of interest from the Italian authors and case law, which have tried, on the one side, to treat it similarly to one of the contractual schemes expressly provided by the Italian Civil Code (lease, sale with reserved ownership or loan) and, on the other side, to qualify it as an "atypical" agreement.

Form

The financial leasing agreement must be drawn up in written form. It is also necessary the transcription of the agreement should the relevant term be longer than nine years (in compliance with the provision of section 2643, No 8, of the Italian Civil Code regarding the "transcription of acts concerning immovable").

Object

The Law 124/2017 defines the financial leasing agreement as an agreement where: a bank (or an authorised financial intermediary) undertakes to purchase, or procure the construction of, an asset selected by the prospective lessee and in accordance with the lessee's instructions, and makes the asset available to the lessee for a specific period of time against the payment of a rent which takes into account the purchase or construction price and the duration of the agreement. Upon expiry of the agreement, the lessee shall have: (a) the right to purchase the leased asset at a pre-agreed price or (b) should the purchase right not be exercised, the obligation to return the asset to the lessor.

As for the main obligations of the parties, the lessee has to: (i) pay the rent, (ii) receive the immovable, (iii) use the immovable in compliance with its destination of use, (iv) perform the ordinary and extraordinary maintenance of the real estate.

On the other side, the main duties of the lessor are: (i) sign the sale and purchase agreement with the seller of the immovable chosen by the lessee, (ii) identify with the lessee the delivery T&C of the immovable, (iii) grant an option right to the lessee for the final purchase of the immovable.

The main contractual clauses, suitable to be applied in accordance with Italian legislation are the following:

Term

It is usually calculated based on the nature of the good chosen by the lessee and the relevant financial treatment. In the case of real estate, the minimum term generally adopted is equal to eight years.

Amount of the rent

According to Law 124/2017, the amount of the leasing rent is calculated taking into account the purchase or construction price of the asset and the duration of the agreement. The rent is generally composed of a principal amount "quota capital" plus interest payments, which are calculated by applying the rate chosen by the leasing company or negotiated by the parties.

Payment of the rent

Usually the lessee has to pay a huge amount (so-called "*maxi-canone*") at the time of entering into the agreement and, afterwards, monthly instalments.

It is also possible to provide for a different periodicity (quarterly, six-monthly, etc).

Redemption price

At the end of the agreement, the lessee has the faculty to purchase the building through the payment of a minimum amount, usually equal to 1% of the original value of the immovable. In general, the lessee also has to pay the expenses and fees concerning the transfer and the registration of the purchase deed. Alternatively, the lessee may generally decide to ask for a postponement of the expiry date of the agreement or to return the immovable to the leasing company.

Termination

The Law 124/2017 states out that, in the case of the lessee's material breach, the lessor will be entitled to terminate the financial leasing agreement. A material breach occurs if the lessee fails to pay six monthly instalments, or two quarterly instalments for real estate assets, or four monthly instalments for other assets.

In the case of termination of a financial leasing agreement, the asset shall be returned to the lessor and the latter shall pay an amount obtained from the proceeds of the sale (or other form of disposal of the asset) at market value, net of an amount equal to the aggregate of (i) any due and still unpaid instalments as at the date of termination of the leasing agreement, (ii) the principal component of any instalment due to expire after the termination date and (iii) the agreed final purchase option price (as well as any costs incurred by the lessor for repossession, valuation and management of the asset for the time necessary to complete a sale).

The above does not affect the lessor's receivable whether the proceeds of the sale of the asset are lower than the amount owed by the lessee to the lessor.

The Law124/2017 does not clarify whether other types of breach made by the lessee may entitle the lessor to terminate the financial leasing agreement.

Costs

Generally, the lessee has to bear the daily expenses (electric power, gas, consumptions, etc) regarding the services used for the activity connected with the immovable.

Additions or innovations

The lessee is not entitled to perform any addition or innovation on the immovable without the lessor’s approval.

Damages to the immovable

Generally, in the event of damage or destruction of the immovable, the lessee is obliged to restore or rebuild the immovable, otherwise the agreement is considered terminated.

Insurance of the immovable

The lessee is generally obliged to enter into an insurance agreement at the lessor’s favour in order to cover the risks for civil responsibility and for the detriment of the immovable.

Sale and lease back agreement

The sale and lease back is a kind of lease agreement in force of which an entity sells to a leasing company an immovable (or movable) asset, which is used in the course of its business. Simultaneously, the leasing company, after having paid the consideration to the selling entity, leases the same asset to the entity itself (lessee), with the provision that the lessee has the possibility to obtain the ownership back of the asset at the end of the lease, by paying a small amount of money.

The sale and lease back is aimed at providing the companies with cash in hand, while they do not lose the availability of an asset that is used in order to carry out their business.

This kind of lease is not ruled by specific legal provisions in Italy, but it is widely used and has been considered by the most recent case law as lawful, subject to certain conditions. More in detail, this kind of agreement has been deemed as unlawful (and void) when the transfer of the ownership is merely aimed at constituting a guarantee for a loan granted to the lessee (as infringement of the prohibition to enter into “*patto commissorio*” agreements).

Tax aspects

Income tax

Real estate financial leasing agreements are executed by financial intermediaries, which are regulated entities, duly authorised by supervisory authorities.

Pursuant to the rules concerning the tax deductibility of financial leasing rentals, applicable to entities drawing up the financial statements in compliance with Italian generally accepted accounting principles (GAAP), for financial leasing agreements executed from 1 January 2014, the business lessee can deduct the rentals, regardless the duration of the financial leasing contract, for a period no lower than the half of the amortization plan (determined by the tax depreciation rates stated by the law for different categories of assets).

With specific reference to financial leasing contracts having as object real estate properties, the tax deduction of the financial leasing rentals for the lessee is allowed in a period no lower than twelve years (regardless the duration of the financial leasing contract).

As far as IRAP is concerned, the amount of the rentals corresponding to interest paid to the lessor is not deductible in the hands of industrial or commercial lessees, due to the irrelevance of interest costs and income for the purpose of the regional tax.

Pursuant to the income tax rules introduced in 2006 in respect of depreciation of lands on which buildings are built/located, the partial non-deductibility regime provided for the depreciation of instrumental buildings owned in property has also been extended to those owned under financial leasing contracts. This is with regard to the amount of the "quota capital" of the periodical rentals corresponding to the value of the lands on which the leased buildings are built/located or representing their appurtenances, determined according to the method stated for instrumental buildings in property (see section "*Direct investment in Italian real estate property*").

The price paid by the lessee to exercise the purchase option, during, or at the expiration of the financial leasing contract, may be integrally deducted in one year, only if not exceeding 516.46 EUR. Otherwise, it will be depreciated over the time provided for by the law (buildings are generally depreciated at an annual ordinary rate of 3%; lands cannot be depreciated).

The lessor is empowered to depreciate the leased real estate property according to the amortisation plan agreed in the contract (so-called "financial depreciation plan").

VAT

For lease contracts concerning real estate properties (including the financial leasing ones), the Italian VAT system provides a general VAT-exemption regime, with some exceptions (see section "*Direct investment in Italian real estate property*").

Registration tax

From 1 January 2011, real estate financial leasing contracts drawn up in the form of public deed or authenticated private deed are always subject to 200 EUR fixed registration tax (as consequence of the alternation VAT-registration tax); contracts drawn up in the form of non-authenticated private deed are subject to registration only in the case of voluntary registration, or "*caso d'uso*" (ie, filing, not required by the law, of the deed for the purpose of administrative activities/proceedings), or if it is mentioned in another document between the same parties which is subject to registration; in these cases, registration tax is levied in fixed amount (200 EUR).

Proportional registration (if any), mortgage and cadastral taxes are levied at the time of purchase of the real estate by the leasing company; conversely, the purchase made by the lessee after exercise of the purchase option upon redemption, or expiration of the leasing contract, is subject to registration, mortgage and cadastral taxes in fixed amount (200 EUR each) – see section "*Lease of property*".

Rent to buy agreement

Legal aspects

The Decree No 133, dated 12 September 2014 (so-called "Sblocca-Italia") introduced the "rent to buy" agreement in the Italian legislation which is a new type of contract related to real estate properties.

The rent to buy agreement main features are: (i) the lease of real estate property to the tenant; (ii) a purchase option right on the real estate property granted to the tenant (only), to be exercised within a specific date; (iii) as per contractual arrangement, part of the rental income paid to the landlord is deemed as advanced payment for the (eventual) real estate purchase.

Tax aspects

With regard to the tax regime of the rental payments, they are treated consistently with their contractual qualification:

- The portion which remunerate the property lease is subject to the tax treatment generally applied to rentals (see above).
- The portion concerning the purchase right option is subject to the tax regime of advance payments (see above).

In the case that the tenant exercises the purchase option, the final purchase price is decreased by the part of rentals deemed as an advanced payment, as set out in the rent to buy agreement.

Conversely, if the option is not exercised, the whole or part (as set out in the rent to buy agreement) of the advanced payments incorporated in the rentals is reimbursed to the tenant (except in the case of tenant's breach of other contractual obligations).

Usufruct

Tax aspects

Income tax

For income taxes purposes, the usufruct owner is deemed to be the owner of the real estate property (see section "*Direct investment in Italian real estate property*").

Indirect taxes

The real right of usufruct is subject to registration tax (at the same rates provided for the transfer of properties to which it refers) at the time when the property and the usufruct are separated. No registration tax is due when they are reconciled (due to the termination of the contract or to the death of the usufruct owner).

The usufruct value is determined by multiplying the "annual revenue" (which is obtained by multiplying the value of the full ownership of the property by the legal tax rate, which from 1 January 2018, has stated at 0.3%) by special coefficients, which depend on the number of usufruct years, or on the age of the usufruct owner for life usufruct.

Transfer of real estate property in Italy

Legal aspects

The Italian legal system requires compulsorily involvement of public notaries in the drafting of sale and purchase agreements for land or buildings, being this activity expressly reserved to them.

Real estate sale and purchase agreement

In accordance with the Italian legal provisions, the sale and purchase agreement is aimed to transfer the ownership of the property against the payment of a defined price. In particular, the immediate effect of the execution of a sale and purchase agreement is the transfer of the title on a specific property from the seller to the purchaser. The transfer of the possession of the sold property does not necessarily occur simultaneously with the transfer of title, as it is possible to postpone it to a later date.

The main obligations of the seller are: (i) to deliver the property to the buyer, (ii) to cause the buyer to acquire the ownership or other right in the property, if the mentioned acquisition is not an immediate consequence of the agreement, (iii) to guarantee the buyer against eviction and defects of the property.

On the other side, the purchaser is bound to pay the price within the term and in the place expressly set by the agreement. Otherwise, the payment has to be made at the time when, and in the place where, the delivery is made. Should the price not be paid on delivery, the payment has to be made at the seller's domicile.

Usually, the purchaser, in order to obtain the necessary funds for paying the price of the property to the seller, enters into a loan agreement with a bank guaranteeing the repayment of the loan raising a mortgage on the property purchased in favour of the bank itself. In these cases, the public notary takes care not only to draft the sale and purchase agreement but also the mortgage deed.

From a general point of view, it is worth noting that the purchaser should ask the seller for the delivery of all the documents and information that give evidence of the compliance and fulfilment of construction and planning permits, safeness certificate and environmental obligation set forth by the Italian legal provisions in connection with the relevant business activity.

Regarding the construction and planning permits and the safeness certificate, contents and release conditions are expressly set forth by the Presidential Decree No 380 issued on 6 June 2001, and its further amendments (ie, Law Decree No 70/2011), concerning the legal provisions and regulations related to constructions (*testo unico dell'edilizia*).

The construction and planning permits should be obtained from the General Constructions Office (*Sportello Unico*) of the Municipality of the place where the property is located in accordance with the specific provisions contained in the regulations of each municipality, district, or region. In particular, such permits are expressly requested not only in the case of new building construction but also in the case of changes to be carried out in order to improve an existing property (by way of example: restorations, change of destination of the property, demolition of old property in order to build a new construction, etc).

As for the safety certificate, the municipality of the place where the property is located should release a document attesting the safeness of the property. In particular, the safeness certificate is released by an expert, after having

carried out adequate inspection activities, and it attests the existence of the conditions listed below, necessary in order to use and inhabit the real estate property (ie, safety, hygiene, healthiness, energy savings of the buildings and installed equipment).

The safety certificate has to be requested from the competent Municipality, not only in the case of a new building construction, but also in the event of a re-construction of a real estate property. In order to obtain this certificate, it is necessary to file, among others, the following documents: (i) an application of land and buildings registration of the real estate property; and (ii) a written declaration issued by the installing company of the property's equipment attesting their compliance with the applicable law provisions together with the certificate attesting the performance of the relevant tests.

From a general point of view, it is worth noting that it is advisable to request the delivery of these documents before the completion of a real estate investment in order to check if the property meets the requirements and the expectations of the investing company. In this regard, it should be noted that the Italian Civil Code expressly provides for the seller's obligation to deliver all documents and certificates pertaining to the ownership and use of the real estate property at the time of execution of the transfer deed. Moreover, please note that, in the event of failure to submit the request for such safety certificate to the competent Municipality, the requesting party shall be subject to an administrative sanction ranging from 77 EUR to 464 EUR.

Furthermore, should the real estate investment operation include the acquisition of a business activity carried out within the purchase property, the buyer should ask the seller to deliver all the documents and information which give evidence of the compliance and fulfilment of any environmental obligation set forth by the Italian law provisions in connection with the relevant business activity.

Among the environmental issues to be checked, specific attention should be given to the non-existence of adverse conditions which may determine a prejudice to the land, air, groundwater or surface water surrounding the property and to human health or the environmental in general.

Therefore, prior to the execution of a real estate sale and purchase agreement, it is generally advisable to perform an environmental due diligence in relation to the property and to the business activity, if any.

This due diligence process should provide the purchaser with a detailed assessment of the historic, current and potential future environmental risks that may arise, by way of example and without limitation, from existing contamination caused by past operations, planned operations and third-party claims for environmental damages.

Pursuant to Italian Civil Code, the real estate sale and purchase agreement may provide a sort of "call option right" in favour of the seller, according to which such party has the faculty to repurchase the title of the sold property upon restitution of the price and reimbursement pursuant to the criteria set forth by law. This faculty may be exercised within a time limit agreed by the parties, which cannot be greater than five years in the sales of immovable. The redemption agreement must be registered in public registers and it is effective against third parties.

At the time of transfer of a property's ownership, the parties are bound to provide the notary with the following documents and/or information: (i) T&C of payment of the agreed consideration for the sale and purchase of the real estate, (ii) mediation (if applicable) of a real estate agent (mentioning the relevant data of the individual or entity involved) and the amount of the commission paid, (iii) energetic certification (where requested by regional laws or regulations).

With reference to the energetic certification, the Legislative Decree No 192 issued on 19 August 2005, as modified by Legislative Decree No 311 issued on 29 December 2006 concerning the energetic efficiency of real estate properties, sets forth that it is compulsory to attach to real estate deeds of transfer and lease agreements, the energetic certification.

In the case of new-built real estate properties, please consider that, pursuant to the Italian legal provisions, the energetic certification shall be released, at the end of the works, by the builder and duly approved by the director of the works. Such certification should be filed with the competent municipality jointly with the declaration attesting the end of the works.

The Legislative Decree No 192 issued on 19 August 2005, modified by Decree Law No 63 issued on 4 June 2013, converted into Law No 90 dated 3 August 2013 with amendments concerning energetic efficiency of real estate properties, stated that the parties shall insert a provision according to which they acknowledge the receipt of the energetic performance certification (*attestato di prestazione energetica*, or APE); furthermore, the parties shall attach a copy of such certification to the agreement.

Should the parties omit to insert and/or attach such acknowledgement, they will be jointly liable and subject to a possible administrative sanction ranging from 3,000 EUR to 18,000 EUR. The payment of such sanction does not release the parties from the obligation to deliver or attach the relevant certification within a maximum term of 45 days.

The energetic performance certification states the energetic performance of the immovable property and provides recommendations for the improvement of its energetic efficiency.

The preliminary agreement

The preliminary agreement is a binding contract whereby the parties agree in writing to enter into a future final real estate property sale and purchase agreement. In general, by means of entering into a preliminary agreement, both parties mutually agree to purchase and sell a specific property, reserving the faculty to further negotiate the exact T&C of the sale.

According to the provisions of the Italian Civil Code, the preliminary agreement must be drawn up in the same form required by the law for the definitive one and therefore it should be executed by a notary deed or certified private deed. Subject to the above, it is a common practice to sign a preliminary agreement without the involvement of the public notary, in order to identify the main T&C of the sale, agreeing to have only the definitive text executed in compliance with the provisions of the law (ie, by a notary deed or certified private deed).

Considering that the preliminary agreement has to be deemed as a commitment to buy the property and to pay the corresponding price (in addition, a security deposit, defined as "*caparra confirmatoria*", is usually paid at the time of execution), it is advisable for the buyer, before the execution of the preliminary agreement, to obtain all the necessary documentation regarding the property.

Generally, the security deposit is qualified by the parties as a down-payment of the purchase price and, as a consequence, treated accordingly at the time of execution of the definitive real estate sale and purchase agreement.

Should the buyer refuse to enter into the definitive agreement, the seller has the right to withdraw from the preliminary agreement, keeping the security deposit. Conversely, in the event of the seller's default, the purchaser has the similar right to withdraw from the preliminary agreement, asking for the payment of an amount equal to two times the security deposit, originally paid to the seller.

Alternatively, the party who is not in default may decide to demand performance, or termination of the preliminary agreement, asking for the compensation of damages.

From a practical point of view, the preliminary agreement should always:

(i) define the property (through the property deed, cadastral documents, etc);

(ii) provide the identification details of the buyer and seller;

(iii) state the agreed-upon final price of the property, the total amount of the security deposit and the modalities of the payment for the relating instalments;

(iv) acknowledge the respect of planning and building regulations, administrative permits and licences, tax provisions, etc;

(v) provide the closing date in which the deed of sale will be executed;

(vi) guarantee the absence of existing mortgages, restrictions, limitations, third-party's rights, etc.

The definitive sale and purchase agreement

The last step in acquiring a property is the signing of a definitive sale and purchase agreement.

This deed has to be signed before a public notary in order to determine the concrete transfer of the property from the seller to the purchaser.

Prior to the execution of the deed, the notary has the obligation to verify – in the local property register and cadastral offices – that the property is transferred to the buyer in the same legal status declared by the seller in the preliminary agreement (free of mortgages, etc).

During the execution of the definitive sale and purchase deed, the notary usually reads and explains to the parties the clauses of the deed, providing the buyer and the seller with impartial advice as to all legal aspects arising from the transaction.

The payment due by the buyer typically includes the purchase price, as agreed between the parties, the notary's fees (calculated as a percentage of the cadastral value of the property as declared in the deed) and taxes arising from the transaction.

The formalities for registering the change of ownership of the property at the Registry of Immovable are performed by the notary, who has followed the transaction within 20 days from the date of execution of the definitive sale and purchase agreement.

Tax aspects

Income taxes

Individuals
Capital gain deriving from disposal of a real estate property realised by an individual not carrying out a business activity (or, however, not connected to such activity) is subject to Italian taxation (IRPEF) only if the real estate property was purchased or built less than five years before its disposal, with the exception of capital gain realised on buildable land disposal which is always taxable.

In the case of resale of gifted properties, the five-year minimum owning period is computed from the date of acquisition by the donor.

Capital gain deriving from the disposal of the residential building used, by either the owner or his/her relatives, as the main residence for the most part of the owning period is not subject to tax, regardless of the duration of the owning period.

In addition, the capital gain deriving from the resale of an inherited property is not taxable.

Upon seller's option (to be expressed in the sale and purchase deed) the taxable capital gain may be subject to a 26% substitute tax instead of taxation in the annual income tax return (this option is not admitted for capital gains on disposal of buildable lands).

Non-resident individuals are liable to Italian taxation for capital gains deriving from the disposal of real estate properties located in the Italian territory, on the basis of the tax rules provided for Italian resident individuals.

Corporate entities
Regarding resident companies (and Italian PEs of foreign entities), the sale of a real estate property generates capital gain if the property has been held as a fixed asset, or revenue if the property has been held as inventory.

In both cases, the related income forms part of the business income and is subject to IRES, at the rate of 24% and to IRAP, at the ordinary rate of 3.9%. Capital gain realised upon the disposal of real estate not representing "stock" (ie, not booked in the financial statement as inventory) and owned for at least three years, can be fully taxed in the tax period of realisation or, upon taxpayer's option, up to five tax periods in equal instalments (only for IRES purpose). The capital gain generally consists of the difference between the consideration received (net of directly attributable expenses) and the net asset value (ie, purchase cost, increased by capitalised costs and tax-relevant step-ups, net of depreciation deducted).

If a real estate property is part of a transferred business (*azienda*), or as a going concern (*ramo d'azienda*), the capital gain on the transfer is subject to IRES only.

A capital gain deriving from the sale of a real estate property located in Italy, realised by a non-resident company without PE in Italy, is subject to Italian taxation (IRES at the rate of 24%) only if the sale occurs within the fifth year following that of acquisition (with the exception of capital gains realised upon disposal of buildable lands, which are always taxable, despite the duration of the owning period).

Indirect taxes

The preliminary agreement concerning the intended transfer of real estate properties is subject to fixed registration tax of 200 EUR and it subject in any case to registration (and to an additional fixed mortgage tax of 200 EUR if it is executed in the form of notarial deed or private deed with authenticated signatures).

In the case that the preliminary agreement provides for a security deposit/earnest account (*caparra confimatoria*), such advance payment is subject to 0.5% registration tax.

Conversely, account payments are subject to registration tax in fixed amount of 200 EUR if they are already subject to VAT (apart the case of real estate transfers for which the alternation between VAT and registration tax does not apply – The VAT treatment of advanced payments generally follows the tax treatment of the underlying promissory real estate transfer), or with rate of 3%. In the case that the advanced payments have the double qualification of "account payments" (subject to VAT) and "*caparra confirmatoria*", the application of VAT prevails.

For more details, see section "*Direct investment in Italian real estate property*".

Real estate investment funds

Investment funds are "instruments" for collective portfolios management. The term "investment fund" (*fondo comune di investimento*) identifies: the autonomous wealth collected from a plurality of investors, through one or more issuances of units, with the purpose of investing the same according to a pre-defined investment plan; divided into units and pertaining to a plurality of investors; collectively managed by an SGR (an authorised

regulated investment fund management company) in the interest of the investors, but autonomously from them (according to Article 1(1)(j) of the Italian Consolidated Law on Finance, enacted by Legislative Decree No 58, dated 24 February 1998 (*testo unico delle disposizioni in materia di intermediazione finanziaria*, or TUF).

The definition mainly emphases the following requirements:

- wealth collection from a plurality of investors;
- assets management in the interests of the investors, but in autonomy from them;
- pre-determined investment policy (with financial nature).

- An Italian investment fund, which has contractual origin, may be set up in the form of: (i) an open-ended fund, in which the investors can redeem at any time their units/shares, according to the rules provided by the fund's regulations; (ii) a closed-end fund, providing for redemption only upon liquidation of the fund and in the other specific circumstances stated by the fund's regulation.
- Further to the implementation of the Alternative Investment Fund Managers Directive, or AIFMD (2011/61/EU), enforced in Italy by Legislative Decree No 44, dated 4 March 2014), the "investment fund" is defined as an "OICR" (ie, undertaking for the collective investment of savings) representing an autonomous pool of assets, divided into units, set up and managed by an authorised professional manager. According to Article 1(1)(k) of the TUF, the OICR is defined as "*body set up to provide the service of the collective management of assets, the capital of which is obtained from multiple investors by the issue and offer of units or shares, managed upstream in the investors' interests and independently by the same and also invested in financial instruments, credit, including credit backed, in favour of subjects other than consumers, by the OICR capital, equity or other fixed or non-fixed assets, on the basis of a predetermined investment policy*".

The management of investment funds represents a "collective portfolio management" activity, which is an investment service that is exercised by professional intermediaries duly authorised by the supervisory authorities. The manager is the asset management company (*società di gestione del risparmio*, or SGR), generally the one that set it up, or even another SGR acting upon specific mandate and upon payment of a management fee for the activities carried out.

Each fund, and each sub-fund, constitutes an independent pool of assets, separated for all intents and purposes from the assets of the SGR, from those of other funds and sub-funds managed by the same SGR and from those of each unit-holder. The fund is solely liable, with its own assets, for the obligations incurred on its behalf by the SGR.

Real estate investment fund (contractual fund)

The real estate investment fund (REIF) is an independent pool of real estate-related assets, divided into units and pertaining to multiple investors. The REIF invests, exclusively or prevalently, in real estate properties, real estate rights and shareholdings in real estate companies. Real estate investments shall not be lower than two-thirds of the total value of the fund (a lower measure is provided in specific circumstances), according to Article 12(2) of the Decree of the Ministry of Economics and Finance No 30/2015.

The REIF is set up as a closed-end fund. It is established by a resolution of the SGR, which also approves the rules/regulation of the fund. It may be created through cash contributions or contributions in kind.

The REIF's pool of assets needs to follow a number of limitations and rules guaranteeing consistency with the fund classification (ie, the primary investment must be in real estate properties) and diversification of risks (ie, limits to investments). For instance, investing in a single real estate asset with a single zoning classification is generally limited to 20% of the total fund's assets. However, exceptions to this limit exist and reserved funds can follow less strict provisions.

Tax regime

The tax regime of Italian real estate investment funds (REIFs) is provided for by Decree Law No 351 dated 25 September 2001 (converted with modifications by Law No 410 dated 23 November 2001, as amended and integrated by several subsequent measures and lastly by Decree Law No 70 dated 13 May 2011 converted with modifications by Law No 106 dated 12 July 2011).

The Italian REIF is not subject to income taxes (IRES or IRAP).

For income generally subject to WHT, for REIFs WHTs are levied as definitive taxation, a part cases in which the law expressly excludes REIFs from WHT (this is the case, for example, of several kinds of interest and income from capital).

REIFs have no access to EU tax directives for lack of subjective and objective requirements. However, because included among subjects liable to income tax (as clarified in 2012), they should benefit from bilateral treaties application.

Decree Law No 70/2011 has divided REIFs into two categories, each one with different tax regimes applicable to investors:

- institutional REIFs; and
- non-institutional REIFs.

Institutional REIFs are those entirely owned by any (or a combination) of the following subjects (defined as "institutional" investors):

a) states or public entities/bodies;

b) undertakings for the collective investment of savings (ie, *organismi di investimento collettivo del risparmio*, or Italian OICRs);

c) pension funds;

d) insurance companies (only regarding investments made to cover "technical reserves");

e) banks and financial intermediaries subject to "prudential supervision";

f) entities indicated in letters a) through e), established in countries included in the Italian "White List" (this list includes countries with specific agreements with Italy for the exchange of tax information – EU Member States are generally included) also allowing the identification of the beneficial owners of income;

g) non-profits/charities (ie, private bodies and companies resident in Italy, which pursue specific mutuality purposes);

h) corporate and contractual SPVs owned for more than 50% by any of the entities listed under the previous letters a) to g).

Foreign institutional investors under letter f) include foreign States, foreign public bodies and foreign subjects corresponding to the listed Italian entities which are subject to "prudential supervision". This last requirement is met if the execution of the foreign subject's activity requires prior authorisation and is subject to compulsory continuous controls according to the laws in force in the foreign State of residence. The execution of this prudential supervision must be certified by the home country's competent authority (if the latter does not have this attitude, the requirement could be proved through other reliable evidences).

The SPVs under letter h) can be established in Italy or abroad, but limited to countries included in the "White List". The control on such SPV can also be indirect (in this case, the percentage of interest must be properly adjusted – eg, an indirect control on 60% of a Luxembourg SPV through 90% of a US corporation, equates to 54% actual control on the Luxembourg SPV).

Non-institutional REIFs are those also owned by other kinds of subjects.

Taxation of investors

Institutional REIFs

REIF profits are taxed upon distribution, by way of a 26% WHT at source (as account payment for investors generating business income; as final payment for all the others).

Italian pension funds and OICRs are exempt from the 26% WHT.

Regarding REIF profits distributed to investors resident in Countries where a treaty against double taxation exists, the more favourable treaty regime can be claimed (in general, reference is made to provisions concerning "interest") if subjective, objective and documentary requirements are met (eg, "beneficial owner" status; tax certificate issued by the foreign tax authority which, for this purpose, is valid until 31 March of the subsequent year).

In addition, the following non-resident investors are exempt from the 26% WHT on REIF profit distributions:

a) foreign pension funds and foreign OICRs established in countries included in the "White List";

b) international bodies established on the basis of International treaties that are valid in Italy;

c) central banks or entities that manage the state's official reserves.

Investors under letter a) are identified making reference to the home country legislation. In particular, the exemption applies to entities, regardless of their legal form, which pursue the same purposes of Italian pension

funds and OICRs. Conversely, formal and not substantial similarity is not sufficient for entitlement to the exemption. The foreign fund, or the competent management entity, must be subject to "prudential supervision".

The exemption does not apply in the case of an indirect investment; however, investments through fully owned corporate SPVs resident in "White List" countries entitle for the exemption.

Non-institutional REIFs

Investors into non-institutional REIFs may be classified in the following three categories:

- institutional investors, regardless of their interest in the REIF (see previous section);
- other investors with no more than 5% of the REIF units;
- other investors with more than 5% of the REIF units.

For this purpose, REIF units are computed at the end of the REIF's FY (or management period, if shorter), including also units owned indirectly, by means of controlled companies/entities.

For institutional investors and other investors with no more than 5% of the units, REIF profits are taxed upon distribution or are tax exempt, according to the same rules applicable to institutional REIFs.

For other investors with more than 5% of the units (ie, qualified investors), the profit accrued by the REIF in its annual report is attributed to the investor (according to the ownership percentage), regardless of its actual distribution:

- For resident investors, this share of REIF profit must be included in the annual taxable income which is subject to tax according to their tax regime/status. The distribution of the REIF profit already attributed to the investors (and taxed in their hands) is consequently not subject to WHT. REIF's accrued income (loss) attributed to the investors increases (decreases) the REIF units' tax cost; REIF profit distribution decreases such tax cost.
- For non-resident investors, instead, REIF profit remains taxable upon distribution by way of WHT, according to the same rules applicable to institutional REIFs (treaty reliefs are applicable as well).

The transfer of REIF units by such non-institutional qualified investors is assimilated to disposal of Italian partnerships qualified interest (whose capital gain is always taxable in Italy, unless the relevant treaty against double taxation allows exemption).

Indirect taxes

As far as VAT is concerned, transactions carried out by the REIF generally follow the same rules applicable to other VAT subjects. The VAT obligations related to the REIF's transactions are administered by the SGR which, according to the law, is the "taxable person" for goods (assets) and services that are acquired/provided on behalf of the REIFs managed (albeit separately from the SGR's own VAT obligations).

Acquisitions of real estate properties carried out by the SGR on behalf of the REIF, as well as maintenance expenses on such properties, entitle the SGR to deduct the input-VAT incurred, if any. This implies that the SGR could be in a large VAT credit position. With specific reference to real estate acquisitions/maintenance expenses performed on behalf of the REIF, the law provides a special refund procedure, generally faster than the ordinary one.

A particular VAT regime is provided for contributions in kind to REIFs of plurality of buildings, leased for their majority: they are treated as on-going business concern contributions, so falling out of the scope of VAT and transfer taxes are due in fixed nominal amount.

With regard to instrumental building transfers, the 4% aggregated mortgage-cadastral tax is reduced to 2% for transactions involving REIFs (either as purchaser, or as seller).

Capital gains realised upon contributions to REIFs of real estate properties and real estate rights, can be subject to a 20% substitute tax in the hands of the contributing entity (in place of the ordinary taxation which, for corporate entities, is expected to apply with an aggregate ordinary rate of at least 27.9%). The substitute tax is payable also in five annual instalments (from the second instalment interest are computed at the European Central Bank's reference rate increased by 1%).

SICAF (corporate fund)

The investment company with fixed capital (*società di investimento a capitale fisso,*or SICAF) is a regulated investment vehicle introduced in 2014, by Legislative Decree No 44 dated 4 March 2014, implementing the AIFMD in Italy.

From a legal-regulatory perspective, according to Article 1 i-bis) of the TUF, the SICAF is a closed-end OICR, set up in the form of company limited by shares with fixed equity and with a registered office and head office in Italy. In a nutshell, it is a closed-end corporate fund.

The SICAF has as a sole objective the collective investment of the savings raised through the issuing of its shares (and other similar financial instruments) and as such, similarly to the REIF, the savings invested have to be collected from a plurality of investors, managed in the interest, but independently, from such investors and in compliance with stated and pre-defined investment policies.

The setting-up of a SICAF requires the prior authorisation of the Bank of Italy, after consulting the Italian Companies and Stock Exchange Commission (*Commissione Nazionale per le Società e la Borsa*, or CONSOB), according to Article 32-quater of the TUF. The SICAF is subject to the regulation and supervision of the same; as a result, the SICAF is obliged to fulfil several requirements, according to Article 35-bis of the TUF and to the Bank of Italy's Regulations on collective asset management services (release of 19 January 2015, as later amended), such as, for example: legal form of joint-stock company, minimum amount of equity, compliance with the "regulatory capital"[1], professional requirements in the hands of the management; and to respect the regulatory provisions aimed, inter alia, to limit and diversify investment risks.

The SICAF may have an internal management or, alternatively, the asset management function may be entrusted to an external professional manager (eg, SGR or another alternative investment fund manager, or AIFM). However, as the SICAF is a share company, the investors may have an influence on the management of the OICR, more than investors in the REIF do have, by way of exercising the typical administrative shareholder's rights (eg, appointment of the directors and other internal bodies).

As closed-end OICR, the SICAF can invest in real estate. It qualifies as real estate SICAF if it invests at least 2/3 of its total value/assets (reduced to 51% under certain conditions) in real estate properties, real estate property rights, shareholdings in real estate companies, Italian or foreign REIFs. In such a case, the favourable tax regime applicable to the Italian REIF (in terms of direct taxes exemption and indirect taxes discounts at fund level; tax exemption or reduction for certain foreign investors with respect to fund distributions (see sections above) applies also to the SICAF, with the sole exception that the SICAF is liable to IRAP: for this purpose, the IRAP taxable base is substantially determined by the difference between commission revenues, if any, and commission expenses, if any (other increasing/decreasing adjustments are provided by law), while the real estate proceeds are in any case not subject to IRAP.

SIIQ – the Italian REIT

The Italian SIIQ (*società di investimento immobiliare quotata*, the listed real estate investment company) is the Italian version of the better known real estate investment trust (REIT) in force in other countries. The SIIQ is an Italian joint-stock company, listed on a regulated market of a EU Member State or a country of the EEA, which invests mainly in properties intended for leasing.

The SIIQ is not a new type of entity, but rather an optional special civil and tax regime; in practice, an ordinary stock corporation, which mainly carries out real estate rental activity, may make an irrevocable election to be governed by such SIIQ civil and tax law regime.

The SIIQ regime was introduced, with effects from 30 June 2007, by Law No 296 dated 27 December 2006, and was subsequently amended several times, most recently by Decree Law No 133 dated 12 September 2014 (converted into Law No 164 dated 11 November 2014).

The SIIQ regime is applicable to companies limited by shares (ie, in the legal form of a S.p.A.), which are Italian resident for tax purposes, provided that the following conditions are met:

- The shares of the company – whose "prevalent" business is the real estate lease activity – shall be listed on a regulated stock exchange of a EU Member State or a country of the EEA, included in the Italian "White List";
- No shareholder shall hold, directly or indirectly, more than 60% of the voting rights in the general meeting, and no shareholder shall participate to more than 60% in the company's profits;
- At least 25% of the shares in the SIIQ shall be held as free float, this meaning that such shares have to be owned, at the time of the option for the SIIQ status, by those shareholders that do not hold, directly or indirectly, more than 2% of the voting rights in the general meeting and no more than 2% of participation in the company's profits.

[1] According to Title III, sections II and III of the Regulations on collective asset management services, the initial minimum share capital of the SICAF is 1 million EUR, fully paid up. This amount is reduced to 500,000 EUR in the case that SICAF is reserved for professional investors.

To this end, the real estate lease business is deemed "prevalent" if "asset test" and "profit test" are satisfied, as follows:

- "asset test": at least 80% of the assets are real estate properties addressed to the rental activity (held in property or pursuant to other real estate rights), shareholdings in other SIIQs, SIINQs (ie, non-listed SIIQs – see below) and (pursuant to Decree Law No 133/2014) units into certain REIFs booked as fixed assets (with particular reference to interests into REIFs, they are relevant only if the REIF is invested for at least 80% in real estate properties and rights for the rental activity, interest in real estate companies and other REIFs carrying on the rental activity, SIIQs and SIINQs);
- "profit test": at least 80% of the SIIQ's annual revenues derive from the aforementioned assets. For the purpose of this test, SIIQ and SIINQ profits that are paid out as dividends from the exempt business (thus deriving from the real estate rental activities) and qualified REIF profit distributions are included. According to Decree Law No 133/2014, also capital gains derived from disposal of real estate properties and real estate rights related to the exempt rental business can be considered for the purpose of the profit test.

From a tax point of view, income deriving from the lease business and from the investments in related SIIQs is exempt from the corporate income taxes in the hands of the SIIQ. Conversely, dividends distributed to shareholders out from the exempt profit are subject to the 26% WHT at source (for non-Italian investors, resident in Countries which have entered into a treaty against the double taxation with Italy, the WHT rate may be reduced under the terms and conditions of the relevant treaty). WHT is not applied to distributions to: SIIQs, Italian pension funds, Italian OICRs (eg, UCITSs, REIFs, SICAVs), private wealth management subject to substitute tax regime.

SIIQs are required to annually distribute at least 70% of the net profit derived from the exempt business available for distribution. In practice, the distribution requirement applies to the net profit derived from: profits from the real estate rental business, profits from shareholdings in related SIIQs and SIINQs and (following Decree Law No 133/2014) profits distributed by qualified REIFs. Pursuant to Decree Law No 133/2014, also capital gains, net of related losses, earned from disposal of the previously mentioned assets related to the exempt business and generating exempt profits are subject to compulsory distribution for at least 50% of their amount, over the two years following their earning.

The SIIQ status may also be extended to Italian resident non-listed companies performing the lease business as their "prevalent" business (ie, SIINQs), provided that (among others) at least 95% of the voting rights and participation in profits are held by a SIIQ, or jointly with other SIIQs.

The SIIQ regime is applicable upon irrevocable option, which has to be exercised before the beginning of the tax period from which the SIIQ status is intended to be applied.

From 2010, this regime may also be applied by Italian PEs of companies resident in the EU/EEA countries included in the Italian "White List", provided that these PEs carry out the real estate lease activity as their prevalent business. In this case, the PE is subject to a 20% substitute tax (while profit repatriations do not qualify as dividend payments and so they are not subject to the dividend WHT).

The option for the special regime implies the realisation, at fair market value, of real estate properties owned and used for the lease business activity. The net capital gain may be subject to a 20% substitute tax (in practice an entry tax) payable up to five years, rather than to the ordinary corporate income taxes.

Capital gains realised upon contribution to the SIIQ of real estate properties may be subject to a 20% substitute tax in the hands of the contributing entity, provided that the assets are addressed to the lease business and are held by the SIIQ for at least three years.

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Japan

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Real Estate Tax Summary

General

In general, foreign corporate investors invest in Japanese property through a Japanese local corporation – a *kabushiki kaisha* (KK), *goudo kaisha* (GK), *tokutei mokuteki kaisha* (TMK), or Japan Real Estate Investment Corporation (J-REIT).

Corporate tax

Japanese companies (and foreign corporations having a permanent establishment (PE) in Japan) are subject to corporate tax at a rate of approximately 34.6%. This tax consists of national corporate tax, national "local corporate tax", plus local taxes. The same rate applies to both rental income and capital gains.

Special purpose companies (the TMK and J-REIT) are taxed at the same rate as above but can qualify for dividend deductibility if certain conditions are met. These are commonly used in the market but, as regulated entities, can be more complicated to set up and maintain.

Loss carryforward

Japanese companies may carry forward past losses. The carryforward period is ten years.

In general, a company may use past losses to set off 50% of current year income for fiscal years beginning on or after 1 April 2018.

There are a number of exceptions to these rules, with the primary exceptions described further below.

Withholding tax (WHT)

Japan imposes withholding taxes on dividends and interest paid to foreign residents. The general withholding tax rate is 20.42%, though this may be reduced by treaty. The withholding tax is a final tax and, if the recipient does not have a permanent establishment in Japan, no tax return is required.

Domestic dividends and bond interest can also be subject to withholding tax, though such tax is treated as a prepayment of tax and is generally creditable in full.

If the property owner is a foreign company, the rent may be subject to withholding (at 20.42%). The sale proceeds may be subject to withholding tax at 10.21%. Here too, the withheld amount is treated as an advance payment of tax. If the withheld amount exceeds the tax later determined to be due, a refund may be claimed.

Other taxes relating to real property

In addition to corporate income taxes, property investors may be subject to the following taxes:

Transfer taxes

When purchasing real properties, registration tax and real property acquisition tax are imposed. For TMKs and J-REITs, special reduced tax rates may apply under certain conditions.

Holding period taxes

For real properties owned as of 1 January of each year, fixed assets tax and city planning tax, where applicable, are imposed.

Stamp taxes

Stamp taxes are imposed on many transaction documents. Unlike certain other countries, stamp taxes in Japan are generally not material.

Consumption taxes

Consumption taxes are a type of value-added tax. The rate is currently 10%.

Real Estate Investments

General

Foreign corporate investors may invest in Japanese real property directly or through a Japanese corporation.

Rental income

Japanese corporations and foreign corporations with a PE in Japan

Japanese corporate investors and non-resident corporate investors having a PE in Japan are subject to tax on their net rental income, ie, gross rent after the deduction of management expenses, depreciation, interest and other expenses, determined on an accrual basis.

The rate is currently approximately 34.6%. This tax consists of national corporate tax, national "local corporate tax", plus local taxes. The same rate applies to both rental income and capital gains.

Special purpose companies (the TMK and J-REIT) are taxed at the same rate as above but can qualify for dividend deductibility if certain conditions are met. These are commonly used in the market but, as regulated entities, can be more complicated to set up and maintain.

If the company has paid in capital of more than 100 million Japanese yen (JPY), it may be subject to "size-based" taxation. A company subject to "size-based" taxation is subject to a slightly lower corporate income tax but is also subject to non-income based taxes determined, based on the company's personnel costs, rent costs, interest and capital.

Special rule for special purpose entities

Special purpose entities established under special laws may deduct their dividends distributed to their investors under certain conditions. These special entities include TMKs incorporated under the Asset Securitisation Law and J-REITs established under the Investment Trust and Investment Corporation Law. The "size-based" enterprise tax does not apply to TMKs and J-REITs.

Foreign corporations without a PE in Japan

A foreign corporation having no PE in Japan is subject to national corporate tax at an effective rate of 25.59% (including national local corporate tax) on net income.

If the foreign company has no PE in Japan, the rent is subject to withholding tax of 20.42%. The withholding tax is normally credited against the corporation's corporate tax liability when filing its Japanese corporate tax return.

In addition, when the foreign company without a PE sells real estate in Japan, the gross proceeds are subject to withholding tax at 10.21%, with such amount creditable when the tax return is filed.

Depreciation

Buildings, structures and attachments to buildings should be depreciated using the straight-line method. Depreciation rates are prescribed by ministerial ordinance.

For machines and equipment, the declining balance method is mandatory, but the straight-line method is allowed by filing certain application in advance.

It should be noted that depreciation is deductible for tax purposes only up to the amount of depreciation claimed for accounting purposes.

Capital gains on the sale of real property

Japanese corporations and foreign corporations with a PE in Japan

For a Japanese corporation, or a foreign corporation having a PE in Japan, capital gains derived from the sale of real property is aggregated with rental income and other business income and taxed at the ordinary national and local corporate tax rates.

Foreign corporations without a PE in Japan

If a foreign corporate investor does not have a PE in Japan, capital gains derived from the sale of real property located in Japan are subject to corporate tax at the rate of 25.59%.

Special tax on capital gains from the sale of land

An additional special tax is imposed on capital gains realised from the sale of land, land rights and shares in Japanese landholding companies. The tax rate is approximately 12% (including local tax) where such property is held for five years or less, and approximately 6% (including local tax) where such property is held for more than five years. The holding period is calculated from the day following the property's acquisition date to the 1st of January of the year in which the transfer takes place, rather than to the actual disposition date. Application of this additional special tax is suspended for land sold between 1 January 1998 and 31 March 2023.

Capital gains from the disposal of certain real estate interests

Capital gains derived by foreign corporations having no PE in Japan from the transfer of shares in a corporation that predominantly holds real estate in Japan are subject to Japanese taxation if, as of the last day of the fiscal year prior to the year of transfer, the above non-resident investor (and special related persons and investment vehicles such as partnerships in which the investor holds an interest) owned more than 5% of the shares in such corporation if the corporation is public or, if the corporation is non-public, more than 2% of the shares.

A corporation will be treated as predominantly holding real estate if 50% or more of the assets of the corporation consist of real estate in Japan, such as land and buildings, and shares in other corporations that hold real estate.

If the foreign corporation without a PE meets the above requirements, it will be subject to corporation tax at the rate of 25.59% (including national local corporate tax) and will need to file a tax return in Japan.

Loss carryforward

Tax losses can be carried forward for ten years, provided that a taxpayer applied for and received permission to file a "blue form" tax return and filed such "blue form" tax returns in the year the loss was incurred as well as continuously afterwards. The use of carried forward tax losses is limited to 50% of current year taxable income.

The tax loss limitation does not apply to:

- Corporations with capital not exceeding 100 million JPY and not wholly owned by a corporation with capital of 500 million JPY or more;
- TMKs, J-REITs, certain Special Purpose Trusts and Specified Investment Trusts to which the dividend deduction tax regime is applied; or
- Corporations using tax losses carried forward to offset debt forgiveness income under the Corporate Rehabilitation Law.

Withholding tax on dividends and interests

Dividends and interest paid by a Japanese corporation are generally subject to withholding tax of 20.42%. This may be reduced by treaty.

Other taxes

Other taxes on the purchase of real property

Registration tax

Registration tax on the acquisition of real property is levied at a rate of 2% based on the assessed value of real property when a change of the ownership is registered with the registry office. The tax rate for land is currently reduced to 1.5% for registration until 31 March 2021 if the ownership change occurs in a purchase of the land.

A further reduction of the registration tax rate to 1.3% is applicable for TMKs and J-REITs under certain conditions, ie, where 75% or more of the assets of the TMK and J-REIT are real properties and the properties are acquired on or before 31 March 2021 and registered within one year after the acquisition date. To be eligible for the reduced rate, certain administrative procedures must be followed.

Real property acquisition tax

When real property is acquired, real property acquisition tax is imposed at a rate of 4% on the assessed value of the real property acquired. The tax rate for land and residential buildings is reduced to 3% for real property acquired on or before 31 March 2021. The tax base of land is reduced to half where the land acquired is classified as land for building (takuchi), and the acquisition is made on or before 31 March 2021. In addition, the tax base is further reduced to two-fifths for TMKs and J-REITs where properties are acquired on or before 31 March 2021 (again, to be eligible for the reduced rate, certain administrative procedures must be followed).

Stamp duty

Stamp duty is payable on the preparation of certain documents. An agreement to transfer real property is subject to stamp duty ranging from 200 JPY to 600,000 JPY (currently 480,000 JPY until 31 March 2022), depending on the transfer price stated in the agreement.

Special land holding and acquisition tax

A special landholding and acquisition tax is generally levied on the purchase price of land if it is larger than a specified size. The special landholding and acquisition tax is currently suspended, and the resumption of the taxation is not yet scheduled.

Consumption tax

Consumption tax is imposed at a rate of 10% on the transfer and lease of a commercial building, but not normally on land. All or part of input consumption tax paid is creditable against output consumption tax received from customers, generally to the extent of the ratio of taxable sale amount over total sales amount, provided that the purchaser has taxpayer status for consumption tax purposes. The lease of a residential building is treated as a non-taxable transaction for consumption tax purposes.

Other taxes on the holding of real property

Land value tax

A land value tax is levied at a rate of 0.3% on the assessed value of land, after certain deductions such as 1.5 billion JPY for an individual under certain conditions. The amount of the deduction varies, depending on the size of the corporation holding the land and the value of the land, as well as other factors. This tax is currently suspended, and resumption of the taxation is not yet scheduled.

Fixed assets tax and city planning tax

A fixed assets tax and a city planning tax, where applicable, with standard rates of 1.4% and 0.3%, respectively, are levied every year on a tax base assessed by the local tax authority.

Special land holding and acquisition tax

A special landholding and acquisition tax is annually levied. The special landholding and acquisition tax is currently suspended, and resumption of the taxation is not yet scheduled.

Business office tax

A business office tax is imposed annually at a rate of 600 JPY per square metre of floor space used for business purposes and 0.25% of the annual payroll, if the floor space is over 1,000 square metres, or if the number of the employees is more than 100.

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Latvia

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Real Estate Tax Summary

Rental income

Individuals

Individuals earning Latvian-sourced rental income should pay personal income tax choosing one of the following regimes:

- to pay personal income tax at a progressive rate (ie, 20%, 23% or 31.4% depending on the amount of profit) applicable to the profit from the commercial activity calculated as income minus expenses;
- to notify the State Revenue Service on the performance of the non-registered commercial activities and to pay personal income tax at the 10% rate on the gross rental income, ie, no expenses can be deducted (except real estate tax).

Companies

Net rental income of Latvian companies should be considered as the ordinary income of the company.

The corporate income tax (CIT) rate at 20% applicable to the taxable base is payable only upon the distribution of financial profits, while re-invested profits are CIT-exempt. Before applying the statutory rate to the taxable base arising from profit distribution for the tax period, the tax base should be divided by the coefficient 0.8.
As the taxable base is increased, the effective rate will be 25%.

Foreign entities carrying out activities in Latvia through a permanent establishment (PE) are also liable to corporate income tax at the effective rate of 25%.

Latvian law also includes the “arm’s length” concept, and the tax authorities may demand that adjustments in transfer pricing are made in transactions between related parties.

Loss carryforward

The CIT Act does not include the concept of tax losses.

Transitional rules stipulate that the tax losses accrued until 31 December 2017 can be utilised by the companies during five financial years (from 2018 to 2022) by deducting an amount equal to 15% of the total loss brought forward from CIT calculated on dividends for the financial year. However, such deduction is capped at 50% of the amount of CIT charged on dividends for the financial year.

As such, newly registered companies are not able to benefit from the tax loss incentives.

Capital gains

Individuals

Gains realised by Latvian resident individuals on the disposal of real estate or of shares in a company with Latvian real estate are taxable at the rate of 20%, unless one of the conditions prescribed by the law is fulfilled:

1. the real estate has been held for at least 60 months and has been declared place of residence for the last 12 months prior the disposal;
2. the real estate has been held for at least 60 months and it has been the only real estate of the taxpayer; or
3. the real estate has been held for at least 60 months and income is invested in a new functionally similar real estate within 12 months prior to or upon the disposal of the real estate.

Foreign individuals selling Latvian real estate (or shares in a company with Latvian real estate constituting more than 50% of its assets in the year of sale or in the previous year) are subject to 20% personal income tax applied to the profit (income minus expenses), whatever the holding period. This is applicable in case the buyer is a Latvian non-resident or resident individual having no obligation to apply withholding mechanism, when purchasing real

estate from a non-resident individual. Otherwise, 3% should be withheld by the Latvian buyer from the gross amount.

Capital loss can occur for individual or sole trader. The individual may use capital losses on an annual basis, whereas the sole trader may carry forward capital losses for three years. Capital losses may be used to offset any type of capital gains income.

Companies

Gains reflected in the books of a Latvian corporate entity constitute a corporate income taxable base to which the CIT at the effective rate of 25% should be applied at the moment of profit distribution. The CIT Act prescribes a taxation relief in case of sale of shares, if the real estate company shares are owned for 36 months prior the disposal, however, this relief does not apply in case the shares are sold in the real estate company or the company located in low tax territory.

Proceeds derived by a non-resident company from the disposal of Latvian real estate or shares in any company are subject to 3% withholding tax (WHT), regardless who is the purchaser (ie, a Latvian or a non-resident company), and the Latvian real estate constitutes more than 50% of the asset value of the company being sold directly or indirectly in the period of disposal or in the previous period. An EU company or company resident of a state having a double tax treaty (DTT) with Latvia may exercise the option to calculate tax on disposal of real estate or real estate company by applying 20% to the taxable base (income minus expenses).

Dividends

WHT does not apply to dividends paid by a Latvian company. However, the standard CIT rate at 20% of the taxable base (dividends divided by the coefficient 0.8) is applied when dividends are distributed.

Real estate tax (RET)

Municipalities may determine a RET rate between 0.2% and 3%.

A RET rate of 1.5% may be applied to buildings that are not maintained according to maintenance requirements.

If a municipality does not announce specific rates by 1 November before the tax period, then statutory rates will apply.

Statutory RET rates are as follows:

- The standard rate of 1.5% on the cadastral value of land, buildings, and engineering structures.
- A progressive rate on dwelling houses, their parts and any parts of a non-residential building that are functionally used for living and not used in trade or business:
  - 0.2% of cadastral values up to 56,915 EUR.
  - 0.4% of cadastral values between 56,915 EUR and 106,715 EUR.
  - 0.6% of cadastral values exceeding 106,715 EUR.
- Up to 3% on uncultivated land capable of agricultural use, unless it is up to one hectare in area or subject to statutory restrictions on agricultural activity. By law, uncultivated land capable of agricultural use is agricultural land that is not used for making or growing agricultural products (including harvesting, grazing, and keeping animals for agricultural purposes) or is not kept in a good agricultural and environmental condition. Municipalities may also determine an extra rate of 1.5% on uncultivated land, and so the total rate on such land may reach 4.5%.

A 3% RET rate applies on buildings under construction if the permitted construction period has expired. The tax is applicable until the building is accepted for use. The rate will be charged on the cadastral value of the related land or on the cadastral value of the building, whichever is higher.

Residential property owned by companies is eligible for reduced rates (0.2% to 0.6%), but only where such property is rented out and tenancy rights properly entered on the Land Register of Latvia.

Cadastral value is determined by considering the type, location and use of a particular property, transaction prices over the previous two years and other factors.

There are certain tax incentives depending on the municipality where real estate is located.

Stamp duty/Transfer tax

The registration of a legal title to real estate is subject to stamp duty of 2% on disposals by sale and 3% on disposals by gift.

Stamp duty is not payable if registration of real estate at the Land Registry is necessary because of a reorganisation. Stamp duty payable to register ownership of immovable property in case of a contribution in kind to a company's capital is 1%.

Stamp duty is calculated as a percentage of the transaction value or cadastral (registered) value, whichever is higher.

Value-added tax (VAT)

A Latvian company or individual must register for VAT purposes if making taxable supplies in excess of 40,000 EUR in any given 12-month period. If within a 12-month period, only one taxable supply is made and this supply exceeds 40,000 EUR, the registration for VAT purposes is not mandatory, provided that other taxable transactions will not exceed the total value of 40,000 EUR within a 12-month period. VAT should be paid for exceeded value of 40,000 EUR.

Foreign taxable persons carrying out economic activity in Latvia must register for VAT purposes in Latvia before carrying out a taxable transactions.

Leases

VAT liability and exemption

With respect to real estate, supplies could be taxable or VAT-exempt, depending on the status of the building.

Generally, residential leases are VAT-exempt while commercial leases are taxable. The lease of commercial property is subject to 21% VAT.

Recovery of input VAT

The implications of exempt and taxable supplies are a significant concern in the property industry, particularly if major refurbishment work has been carried out. This should, therefore, be carefully considered in a business plan. If a Latvian company or individual exclusively make exempt supplies, it cannot recover any VAT on its costs. If exclusively taxable supplies are made, all of the VAT incurred on costs is recoverable, provided the costs are valid business expenses. However, when a company or individual make both exempt and taxable supplies, it is likely that only a proportion of the VAT on expenses will be recovered, based on the ratio of exempt to total supplies. There are, however, opportunities to allocate costs more specifically to specific supplies if this produces a more favourable result.

Sales

VAT liability and exemption

The sale of immovable property is VAT-exempt, except the sale of unused immovable property and building land. Sales of unused immovable property and building land are subject to 21% VAT. Latvia has introduced an option to tax provisions in respect of VAT on real estate transactions.

Building land is a plot of land regarding which a construction permit for building thereon or for the construction of engineering communications therein, or for the construction of roads, streets or engineering communications input scheme intended for it has been issued after 31 December 2009. The plot of land shall not be deemed a building land if the construction permit for construction works has been issued:

(i) until 31 December 2009 and has been extended or re-registered after 31 December 2009;

(ii) after 31 December 2009, but the purpose for the use of the plot of land has been changed and does not provide for building thereon.

Unused immovable property is:

(i) a newly built building or structure (also stationary equipment installed therein), or a part thereof, if it is not used after being accepted for service, and a land parcel or a part of a land parcel related thereto;

(ii) a newly built building or structure (also stationary equipment installed therein), or a part thereof, if such is used and sold for the first time within one year after being accepted for service, and a land parcel or a part of a land parcel related thereto;

(iii) a building or structure, or a part thereof, if after renewal, rebuilding or restoration works have been completed it is not being used, and a land parcel or a part of a land parcel related thereto;

(iv) a building or structure, or a part thereof, if after renewal, rebuilding or restoration works have been completed it is being used and sold for the first time within one year after being accepted for service, and a land parcel or a part of a land parcel related thereto;

(v) an object of uncompleted construction, or a part thereof as well as a building or structure, or a part thereof, if such building or structure has not been accepted for service, and a land parcel or a part of a land parcel related thereto;

(vi) a building or structure, or a part thereof, if such building or structure is being renewed, rebuilt or restored, but it has not been accepted for service yet, and a land parcel or a part of a land parcel related thereto;

Renewal is construction work as a result of which the deteriorated load-bearing elements or constructions of a structure have been replaced or functional or technical improvements have been made without changing the dimension of the structure or the load-bearing capacity of elements.

Rebuilding is construction work as a result of which the dimension of a structure or part thereof has been changed or the load-bearing elements or constructions have been strengthened, with or without changing the type of use.

Restoration is construction work which is performed for a scientifically justified renewal of a structure or part thereof, using materials, methods or technologies corresponding to the original.

Taxable value in a transaction of supply of unused immovable property or building land mainly is the sale price. In certain cases, taxable value is the difference between the sales value of a building and the value of such building before the commencement of the renewal, rebuilding or restoration works.

Recovery of input VAT

Input VAT incurred upon construction works, renewal, rebuilding or restoration is recoverable if the building is intended to be used for taxable transactions. The taxable person should follow the deducted input VAT for ten years, that is, follow whether the actual use of real estate is not different from the planned one and no adjustment of the deducted input tax is required.

Real Estate Investments

General

As a general rule, land, and any building set on the land, is treated as a single object for the purposes of registering title and acquisition. Occasionally, buildings can be acquired separately from land. In such cases, the land can be acquired subject to the conditions outlined below.

Land can be acquired by Latvian, EU citizens and by Latvian- and EU-registered companies, where all shares in these companies belong to Latvian, EU citizens or residents – either corporate or individual – of countries with an effective investment protection treaty with Latvia. Other persons may own land only after obtaining special permission from the municipality where the land is situated. Additional restrictions exist if a non-resident wishes to purchase agricultural, forestry or border land, or land in designated national parks. Namely, from now on, agricultural land can be acquired only by citizens of the European Union, or Member States of the European Economic Area as well as Swiss Confederation who have received a document proving the knowledge of Latvian language at least according to level B2. Identical conditions apply also to the shareholder or shareholders of legal persons who jointly represent more than half of the company's voting capital and who have the right to represent the company. There are also restrictions prescribed by the law regarding the amount of agricultural land that may be acquired.

There are no restrictions on the acquisition of buildings by foreigners in Latvia. Foreign investors may also lease land without restriction.

No currency restrictions are imposed on Latvian companies and individuals, who are allowed to maintain freely transferable foreign currency accounts inside and outside Latvia. No foreign exchange restrictions are imposed on cross-border currency transfers.

Investing through a local entity versus direct investment

A foreign company wishing to invest in Latvian real estate through a local entity can incorporate a private limited liability company – *sabiedrība ar ierobežotu atbildību* (SIA) – or a joint-stock company – *akciju sabiedrība* (AS). In most instances, a foreign investor will consider setting up a subsidiary in the form of a SIA, due to cost and ease of registration.

Taxation of a foreign company investing directly in real estate will depend on whether or not the company creates a PE in Latvia. The taxation regime applicable to a PE is quite similar to that applicable to a limited liability company (SIA).

A PE can be registered directly with the tax authorities and it is no longer necessary to legally register such an establishment with the enterprise register as a branch.

Withholding tax (WHT)

Generally, the following payments made by Latvian companies to non-resident companies are liable to WHT at the following rates:

Recipient	**WHT rate (in%)**					
	Dividends[1]	Interest	Royalties	Management fees[2]	Disposal of real estate	Rent of real estate
Non-resident companies and related Latvian companies using certain CIT reliefs	0	0	0	20	3	5
Companies in tax havens [3]	20	20	20	20	20	20

1 No WHT, except tax haven companies.

2 Payments to residents of DTT countries are not subject to WHT, provided that the non-resident does not have a PE in Latvia and a residence certificate is available.

3 20% WHT applies to all payments to companies located in tax havens. Goods/securities acquired at market prices are exempt.

Capital gains

Capital gains generated by Latvian companies or Latvian PEs should be added to the taxable base and taxed at the effective rate of 25%. Capital gains are calculated as a difference between sale proceeds and the property's net book value. No concept of a balancing charge remains since tax allowance is abolished for tax purposes.

Capital gains derived by foreign companies without a Latvian PE are not taxed in Latvia. Nonetheless, such proceeds would be subject to 3% WHT on the sale of Latvian real estate or shares in a company with Latvian real estate constituting more than 50% of its asset value if the purchaser is Latvian resident. If the purchaser is non-resident, either the tax rate of 3% on proceeds or of 20% on profits shall be applied.

Financing the property

Debt

Under thin capitalisation rules, interest should not be added to the corporate income taxable base if paid on loans obtained from an EU-registered credit institution or a credit institution in a country with which Latvia has an effective tax treaty.

If obtained elsewhere, it should be added to the corporate income taxable base after the certain limit. Two calculations should be made and the one that results in the higher amount should be added to the taxable income. The calculations are as follows:

- Method 1: Interest exceeding the 30% EBITDA of the loan receiver should be added to the taxable income, if the receiver's annual interest expenses exceed 3 million EUR solely.
- Method 2 anticipates that interest is not added to the taxable income, if the average liability does not exceed four times shareholders' equity at the beginning of the tax year minus any revaluation reserve.

If a company's interest expenses are less than 3 million EUR per annum, only method 2 shall be followed.

If loans are taken for the purpose of construction or development, the interest paid before the completion of the building can be added to the book value of the property and depreciated for financial purposes. For tax purposes, tax allowance is abolished.

Equity

The minimum share capital of a private company is 2,800 EUR, which must be contributed either in cash or in kind. There is a possibility to register an entity with lower share capital if certain criteria are complied with.

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Real Estate Going Global

Lithuania

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 18 August 2020.

Real Estate Tax Summary

General

Real estate, as defined by the Lithuanian Civil Code, consists of land and assets related thereto that cannot be moved from one place to another without changing their purpose and essentially reducing their value, and also the assets that are defined as such in the relevant laws.

The constitutional law provides that agricultural, non-agricultural and non-forestry land, inland waters and forests may be acquired and owned by foreign legal entities and individuals who comply with the criteria of the European and transatlantic integration. These criteria mean, that a person shall originate from the country, which is a member of the European Union (EU), NATO, European Economic Area (EEA) or OECD organisations and not a member of any organisation founded on former Soviet Union basis. A person who is eligible according to aforementioned criteria can acquire land under the same procedure and conditions as applied to Lithuanian citizens and legal persons.

Nevertheless, Lithuanian legislation may establish specific procedures and limitations regarding acquisition of agricultural and forest land or state-owned real estate objects. Most recent limits are set with regard to the maximum ownership amount of agricultural land (in certain cases up to 500 hectares) and forestry land (in certain cases up to 1,500 hectares), controlled by the National Land Service.

Foreign legal entities and individuals who do not comply with the criteria of European and transatlantic integration are not permitted to acquire ownership of land, inland waters and forests in Lithuania. Following the court practice of the Supreme Court of Lithuania[1], this restriction shall also be applicable for companies set up in Lithuania by the abovementioned restricted persons. However, they may possess or use land, interior waters, forests and parks, by way of lease or any other agreement that confers the use of the land, but not the title thereto.

Both domestic and foreign individuals and legal entities may be parties to lease contracts. The term of a land lease may be fixed by the parties and though such term for state land may not exceed 99 years (for the state-owned real estate properties available terms may be shorter), an expired lease can be renewed by the parties to the land lease contract. The terms and conditions for the lease of state land are determined by the government. In respect of state land, the lease contract is concluded by the authorities following a standard contract format. The approval from the National Land Service for the lease of the land is also required. When private land is leased, the terms of the lease will be mutually agreed upon by the private owner and the lessee.

In respect of the acquisition and lease of other immovable property, such as buildings, there are no specific requirements or restrictions stipulated by national legislation for foreign investors. In most cases, the general provisions of the Lithuanian Civil Code will apply.

Rental income

Net income received by corporate taxpayers is taxable in Lithuania at the general corporate income tax (CIT) rate of 15%. Income derived from real estate located in Lithuania is considered as income from general economic activity and taxed at the standard CIT rate of 15%.

For local and foreign individuals' income from rent of real estate located in Lithuania is generally subject to 15% personal income tax (PIT) if income amounts do not exceed 148,968 EUR per calendar year (2020). The 20% PIT rate is applicable to income exceeding this threshold (other income should be also added to this threshold).

Withholding tax (WHT)

Certain income sourced in Lithuania and received by a foreign entity otherwise than through its permanent establishments (PEs) in Lithuania is subject to WHT. Proceeds from sale or lease of immovable property located in Lithuania received by a foreign company are subject to WHT in Lithuania at the rate of 15%.

[1] The Supreme Court of Lithuania in the case No 3K-3-68/2015 declared real estate deals concluded by Lithuanian legal entity registered and owned by citizens of Belarus, void since it was considered as cover-up deal to help Belarus citizens acquire land.

Capital gains tax

A capital gain is equal to the difference between the net sales proceeds and tax book value. Capital gains of residents and non-resident companies are taxed as general taxable income at the rate of 15%. Certain exemptions may be applied to capital gains derived by Lithuanian resident holding companies or PEs of foreign companies. For more detailed information, please see below.

For local and foreign individual's capital gain on sale of real estate located in Lithuania generally is subject to 15% PIT if profit does not exceed 148,968 EUR per calendar year (2020). The 20% PIT rate is applicable to income exceeding this threshold (other income should be also added to this threshold).

Thin capitalisation rules

Thin capitalisation restrictions apply to interest paid to controlling entities. A debt-to-equity ratio of 4:1 and interest attributable to non-deductible expenses if this ratio is exceeded.

Tax loss carryforward

Losses from operating activities can be carried forward for an indefinite period of time as long as activities from which the losses were accumulated are continued. Losses incurred from disposal of securities or derivative financial instruments can be offset with the income of the same nature and can be carried forward for the period of five years starting from the year after such losses were incurred. However, losses carried forward cannot offset more than 70% of taxable income of the entity in any tax period. The 70% limitation does not apply for losses from disposal of securities or derivatives.

Depreciation

The depreciation of buildings and other structures is calculated separately for each asset. Generally, buildings may be depreciated over periods from eight to 20 years. New buildings may be depreciated either using a straight-line or double declining balance method. All other buildings may be depreciated using only the straight-line method.

Land is not subject to tax depreciation.

Value-added tax (VAT)

According to the general rule, sale of new buildings (in use for less than 24 months after their completion), unfinished buildings, building land or land with new buildings is subject to VAT at the standard rate of 21%. Sale of buildings 24 months after their completion or reconstruction as well as land is VAT-exempt, with an option to apply VAT if the purchaser is a taxable person registered for VAT purposes.

Rent of real estate (buildings and land) is generally VAT-exempt, with certain exceptions for residential premises and premises for parking of vehicles, etc. Whereas rent is VAT-exempt according to the general rule, a VAT payer is entitled to opt for taxation, ie, VAT can be charged on rent of the property if the customer is a taxable person registered for VAT purposes. If a company exercises this right in respect of one rent transaction, the same VAT treatment should apply to all analogous transactions for at least 24 following months.

Real Estate Investments

Acquisition and sale of real estate

Tax aspects

In Lithuania real estate can be acquired either directly (asset deal) or by acquiring shares in a company holding real estate (share deal).

In case of an asset deal, the transfer of real estate is subject to notary and registration fees in Lithuania, which were slightly reduced recently and amounts as follows:

- Notary fees vary from 0.37% on the value of real estate; however, the fees shall not be less than 33 EUR or exceed 5,000 EUR for one transaction.
- State duties imposed upon the registration of a real estate transfer are typically not material and vary depending on the real estate value (up to 1,448.10 EUR for legal entities and 289.62 EUR for natural persons). From 1 October 2020, another amendment will come into force: regardless of the price of real estate, registration of ownership changes will cost equally, ie, for registration or deregistration of the ownership right to the immovable costs should not exceed 22 EUR (depending on the type of real estate object).

In case of a share deal (the direct legal owner of real estate remains the same) the transfer of shares in a real estate holding entity is subject to the notary confirmation and respective fees only in the cases prescribed by the law. The share deal transactions shall be confirmed by the notary in separate cases when (i) sale-purchase agreement pertains 25% or more of closed joint-stock company's shares, or (ii) the price of shares exceeds 14,500 EUR. Notary fees vary from 0.33% to 0.41% on the value of sale-purchase agreement value; however, the fees shall not be less than 17 EUR or exceed 5,000 EUR for one transaction.

Capital gains

Disposal of real estate in Lithuania can also be affected either by selling the property (asset deal) or by selling shares in a company holding real estate (share deal).

Capital gains derived by local companies are considered business profits and are liable to the standard corporate income tax of 15%. Income derived by a foreign company from the sale of real estate registered in Lithuania is taxed as indicated in the section "*Withholding tax*".

Sale of shares of a Lithuanian company holding real estate is subject to general taxation rules for sale of shares (ie, there are no specific taxation due to the real estate being the main assets of the company). The actual taxation, however, depends on a number of various criteria and circumstances, eg, the seller (ie, corporate or individual and local or foreign tax resident), shareholding proportion (ie, percentage of total shares held and shares to be sold), holding period, etc.

Capital gains on the transfer of shares are exempt from corporate income tax provided that the following conditions are met:

- The company is transferring shares of an entity that is subject to corporate income tax or similar tax and is registered or otherwise organised in an EEA State or in other countries with which Lithuania has a double tax treaty (DTT).
- The transferring company holds over 10% of shares of that entity for more than two years (in case of reorganisation as defined in the Lithuanian Law on Corporate Income Tax – for more than three years).

Withholding tax

Generally, income of a foreign entity in Lithuania not derived through a PE is considered as Lithuanian-source income and is subject to WHT at the following rates:

- interest on any type of debt obligations, including securities: 10%;
- proceeds from the sale, transfer (with title), or lease of immovable property located in Lithuania: 15%;
- income derived from sports activities or performers' activities: 15%;
- income from distributed profits: 15%;

- royalties: 10%;
- annual payments (management bonus) to the members of the board or supervisory board: 15%;
- indemnities received for the infringement of copyrights or neighbouring rights: 10%.

Dividends

Dividends distributed by a resident company to another resident company are subject to a 15% CIT, which is withheld by a distributing company.

The dividends distributed by a resident company are exempt from WHT if the recipient company has held not less than 10% of the voting shares in the distributing company for at least a 12-month period and the distributing entity is subject to 5% or 15% Lithuanian CIT rate. However, this relief is not applied if the foreign entity (recipient) is registered or otherwise organised in a target territory (offshore), which is included in the specific list approved by the Ministry of Finance of the Republic of Lithuania. Please note that the requirement of the 12-month holding period does not necessarily have to be fulfilled on the day of dividend distribution.

Dividends distributed by a foreign company are subject to a 15% WHT that is to be paid by the receiving Lithuanian entity.

Dividends distributed by a foreign company to a Lithuanian company are exempt from WHT if the distributing foreign entity is established in the EEA and related profit is properly taxed in the domiciled country.

The dividends are also exempt from WHT if the recipient company has held not less than 10% of the voting shares in the distributing company for at least a 12-month period and the receiving entity is subject to 5% or 15% Lithuanian CIT rate. This participation exemption satisfies the requirements of the EC Parent-Subsidiary Directive. The exemption also applies to dividends paid by non-EU foreign companies, except those registered or organised in blacklisted territories.

Interest and royalties

Generally, interest and royalties paid by a Lithuanian company to a foreign company is subject to WHT at the rate of 10%.

However, interest paid from Lithuanian companies to foreign companies established in the EEA or in countries with which Lithuania has a DTT is not subject to WHT in Lithuania.

Royalties paid to the qualifying related parties meeting requirements of the EC Interest and Royalty Directive, are not subject to WHT in Lithuania.

Value-added tax

The sale of a new building is subject to VAT at the rate of 21%. A new building is defined for VAT purposes as an unfinished building or structure as well as a finished building or structure for a period of 24 months following its completion or following its substantial improvement.

Sale of real estate used for more than 24 months is VAT-exempt. Exemption from VAT is also granted on the sale or any other transfer of land (except for land transferred together with a new building that has been used for less than two years, and land for construction) where, under the contract conditions, the person to whom land is transferred, or a third party, acquires the right to land at their disposal as an owner.

However, a Lithuanian VAT payer has an option to tax generally VAT-exempt sale of real estate, including land if the real estate is sold to another Lithuanian VAT payer being a taxable person who performs business activities or to legal persons established under diplomatic and consular arrangements or to institutions of the EU, the European Investment Bank (EIB), the European Central Bank (ECB), even if these legal persons are neither VAT-registered nor do they perform business activities. This option is valid for not less than 24 months for all transactions concluded by a taxable person and related to the sale of immovable property. The taxable person shall declare this option in the manner prescribed by the Central Tax Administrator.

The transfer of shares of a real estate holding company is generally exempt from VAT, however, if the value of shares is equal to the value of real estate the transaction from VAT perspective may be considered as sale of immovable property.

VAT reverse-charge regarding construction services

In Lithuania, a local VAT reverse-charge mechanism applies to the supply of construction services when such services are supplied to a taxable person/VAT payer. In this case, if construction services are supplied in Lithuania

by a foreign entity to the Lithuanian taxable person/VAT payer, the foreign entity is required to be registered in the Lithuanian VAT payers' register and apply local VAT reverse-charge mechanism for construction services.

In addition, VAT reverse-charge mechanism is applicable to supply of goods installed in immovable property in which construction services are performed and after such installation the goods become an integral part of the property, if the goods are supplied under a single agreement concluded for supply and installation services and (or) construction services.

Personal income tax

For local and foreign individuals' sale of real estate located in Lithuania is subject to 15% PIT if income amounts do not exceed 148,968 EUR per calendar year (2020). The 20% PIT rate is applicable to income exceeding this threshold. Tax is levied on the capital gains, ie, sales proceeds less acquisition costs (however, a foreign individual can achieve this only by submitting an additional request for re-calculation of tax to the Lithuanian Tax Authority, since initially the tax is calculated on the gross proceeds).

Collective investment undertakings

Lithuanian legislation allows establishing special collective investment undertakings (CIU) for investments in real estate. Investment income received by these undertakings are not subject to corporate income tax, however, quite strict requirements have to be met. Furthermore, undertakings in the form of investment fund may register for VAT purposes; however, a management company managing the investment fund will be liable for their VAT obligations.

Legal aspects

Formalities

Acquisition of real estate can be exercised if real estate is formed as a real estate object and registered in the Real Estate Register.

Any real estate acquisitions when real estate is acquired directly (asset deal), shall be implemented by concluding written agreement, which must be certified by notary public.

There is no obligatory requirement to register transfer of ownership in the Real Estate Register. Although, in case the agreement is not registered, it may not be invoked against third parties.

In case an acquisition object is only a building without land occupied by the building, the owner's rights to land plot occupied by the building must be settled in the agreement (consent from the landowner must be received in certain cases). Otherwise, the agreement shall be void.

The National Land Service ensures that requirements of the legal regulations regarding state-owned land are fulfilled, and limitations followed:

- The sale of the buildings or other real estate objects on the leased state-owned land could be implemented only subject to the prior consent of National Land Service;
- National Land Service issues certificates to buy/sell agricultural land/forestry land plots and checks the compliance with maximum land amounts ownership limits, proper implementation of pre-emption rights, etc.

The settlements for the acquisition deals pertaining agricultural land ownership may be implemented only by bank transactions.

Acquisition of state-owned real estate properties could be implemented through the process of privatisation. Most common way of state-owned properties privatisation is through a public auction. For the latter procedures, property must be included in the list made by the Government or Municipality to be sold in the auction.

Moment of acquisition

The acquirer of the real estate acquires the ownership right to the property as of the moment it is transferred to him. The moment of acquisition is documented by a transfer and acceptance deed. The deed of transfer and acceptance may be concluded as a separate document or included as an addition to sale and purchase agreement.

Restrictions

Object of real estate sale and purchase agreement may be restricted with various types of limitations like servitudes, usufructs, mortgages, lease rights, pre-emptive rights and other limitations or special conditions. Only restrictions, which are registered in Real Estate Register, are binding to the acquirer. However, in case it is proven that acquirer was duly informed about disclosed restrictions, such restrictions may also be imposed on him.

The Law on Specific Conditions for Land Use was adopted, and main provisions thereof came into force from 1 January 2020. This Law establishes special land use conditions (which was previously governed at the Governmental decision level), specifies the territories in which these conditions shall be applied, regulates procedures regarding the establishment, amending or cancelation of special conditions in these territories as well as creates legal preconditions for the centralised and efficient registration of such limitations in the Real Estate Register.

Following recent land regulations some specified restrictions regarding sale of agricultural land and forestry land were established.

The Law on Acquisition of Agricultural Land sets up to ownership limit up to 500 hectares[2] per person and persons (entities) related to him. In this case "related person" shall mean (i) spouse, children and parents of a person acquiring the land or (ii) related entities – whose 25% of shares are owned by considered person/entity or the ones, which owns 25% of that entity (parent companies).

In case agricultural land is bought from the State, a single person/entity or a group of related persons/entities together can own up to 300 hectares of state agricultural land.

The Law on Forestry sets up an ownership limit and restrictions on forest land acquisitions establishing that a single person or a group of related persons/entities can only own up to 1,500 hectares of forestry land. In order to acquire forestry land or at least 20% of a company, which owns at least 400 hectares of forestry land, the approval from the National Land Service shall be granted. Government-owned forest land cannot be leased for forestry activities.

Pre-emptive rights

In case where a real estate object belongs to several owners, co-owners shall enjoy the pre-emptive right to buy the parts of real estate sold by co-owner at a price at which it is sold to third party. If this rule is violated, the co-owner has a right to claim for transfer of the buyer's rights and obligations pursuant to the sale and purchase agreement on him. The only exception of this rule is when sale takes in the form of the public auction. Furthermore, when land plot on sale is located in certain protected territories (for example, regional and national parks or reservations), state has the pre-emptive right to acquire such land plots. Price for such land plot is limited to its average market value. The pre-emptive right to buy a land plot is guaranteed to a person who owns a building on such land plot. With regard to the agricultural land plots all agricultural companies and natural persons acting in the particular or neighbouring municipality, as well as persons who had used particular land for agricultural purposes for at least a year (except when the usage was free of charge unless it was given to a close relative), have pre-emptive rights to buy the agricultural land. In addition, to general pre-emptive rights, forestry landowners have pre-emptive right to buy neighbouring forestry land.

Concentration

Competition Council shall be notified, and permission is required when the general income of enterprises concerned is more than 20 million EUR for the financial year before concentration and the general income of each of at least two enterprises concerned is more than 2 million EUR for the financial year before concentration.

Preliminary negotiations and contracts

During the pre-contractual relationships, negotiations can be conducted freely, although parties are obligated to negotiate in good faith. A party who begins negotiations or negotiates in bad faith shall be liable for the damages caused to the other party.

Parties usually conclude a preliminary contract before the actual sale and purchase agreement. Provisions of the preliminary contract are compulsory to the parties. If the party does not agree to conclude an agreement as settled in the preliminary contract, that party takes a risk of other party being entitled to claim damages for violation of the preliminary contract. It is recommended to negotiate liquidated damages in the preliminary contract. In case

[2] 500 hectares limitation for agricultural land could not be applied for a person who use agricultural land for animal breeding if number of animals does not exceed allowed numbers (1 animal/1 hectare).

preliminary contract is registered in the Real Estate Register, third parties shall be prevented from acquiring such real estate.

In the preliminary contract, the parties are obliged to establish a time limit within which the main agreement must be concluded. If such time limit is not established, the main agreement must be concluded within one year from the date of the conclusion of the preliminary contract. In cases the main agreement is not concluded within that the prescribed time without any unfair or unreasonable actions from any party, obligation to conclude such main agreement ends.

Asset transfer, share transfer and business transfer

There are three ways to conclude a real estate transfer: asset transfer, share transfer and business transfer. The latter is not commonly used in practice.

If parties choose on asset deal, following issues should be considered: firstly, all lessees of the real estate property will have a statutory right to cancel lease due to the change of ownership. This may be important when transferring such property as shopping centre or offices. In practice, it is usual to waive this right. However, it is not clear if such waiver would be enforceable. Secondly, asset transfer is more expensive due to taxes for notary public and other public services. Though, due diligence of asset transfer is usually less expensive than share transfer.

When exercising share transfer, following issues should be considered: firstly, share transfer could be subject to smaller state fees. Secondly, due diligence is much wider in scope as it involves transfer of the whole enterprise, including all risks they may arise after the change of ownership. Transfer of shares is substantially riskier compared to transfer of assets only, as it involves all potential risks, obligations and claims from third parties.

Collective investment undertakings

Only a private (UAB) or public (AB) limited liability shall have the right to engage in the management of CIU. A license from the Bank of Lithuania (central regulatory body for financial transactions) is required to pursue previously mentioned activities.

The real estate investment company, whose assets' management has not been delegated to the management company, must ensure that the real estate objects comprising the investment portfolio of the CIU are evaluated by independent qualified property appraisers following procedures established by the law.

The investment portfolio of real estate property has to be diversified according to the Law on Collective Investment Undertakings. For example, no more than 30% of the assets of a real estate property collective investment undertaking may be invested in one object of real estate and/or real estate company.

Mortgage

A mortgage is the pledge of real estate to secure the performance of contractual obligations. The mortgage is under the basis of the mortgage agreement or mortgage provisions could be stipulated in the main agreement directly. Only in the Mortgage Register registered mortgage agreements may be invoked against honest third party, however for the parties the mortgage takes effect as of the date of conclusion the notarised mortgage agreement. Perfection of mortgage are carried out by notary public (including issue of the receiving order for recovery proceedings performed by the bailiff).

The enterprise may be pledged as a real estate (pool of assets). The main idea of this regulation is that the pledge is not tied to a particular property at the particular time. The company will be able to dispose its own property despite the mortgage, unless the mortgage agreement specifies the disposal restrictions.

Lease of real estate

Tax aspects

Rental income

For local Lithuanian entities income from rent of real estate is considered as taxable income which is in general subject to 15% CIT under regular taxation rules of company business activities (ie, companies' profit is taxed). The reduced CIT rate applies for small companies, ie, entities with fewer than ten employees and less than 300,000 EUR in gross annual revenues can benefit from the reduced CIT rate of 5% (0% rate for the first year of operation) if certain conditions are met. All income of real estate collective investment funds (eg, rent, capital gains) are exempt from CIT if certain conditions are met.

For foreign entities income from rent of real estate located in Lithuania is subject to 15% WHT. WHT is levied on the total proceeds of rent. The risk of constituting a taxable presence (ie, the so-called permanent establishment) in Lithuania due to business activities within the country should be considered.

It should be noted, however, that where there is a DTT in force between Lithuania and the foreign country, the provisions of that treaty should be considered.

Where a PE is deemed to exist, the foreign company is subject to apply the same taxation regime as a Lithuanian resident entity.

Leasing provisions

Real estate could be leased either on a financial or operational basis.

Lease, where the ownership is transferred to the lessee as the owner of the asset upon the payment of last instalment, is considered financial lease. Under financial leasing, the lessee (user) is treated from a tax perspective as the owner, the depreciation of assets that are the object of a lease agreement may be utilised by the lessee.

Lease where the lessor retains all the risk and benefits of ownership of the asset is classified as operating lease. From tax perspective, operating lease payments are recognised as an expense in the profit (loss) statement on a straight-line basis over the lease term. Under operational leasing lessor is treated as the owner ow the assets. The depreciation of leased assets is utilised by the lessor.

Personal income tax

For local and foreign individuals' income from rent of real estate located in Lithuania is subject to 15% PIT on gross income for the income amounts (not including employment related income) not exceeding 148,968 EUR per calendar year (2020), and the 20% PIT rate is applied on the part exceeding this threshold. If rental income is received from registered individual activity, PIT is levied on the profits (income less expenses). Upon certain conditions, individuals can opt to pay a fixed amount of tax on rent of privately owned real estate once a year.

Value-added tax

In general, letting of real estate is VAT-exempt, with some exceptions provided below:

- Provision of accommodation services in hotels, motels, camping sites or in sectors with a similar function;
- Letting of other residential premises for a term not exceeding two months;
- Letting of premises, sites, garages for parking or keeping of any means of transport (including aircraft, ships, rolling stock), or other property with a similar function, immovable by its nature;
- Letting of any permanently installed equipment (including safes) falling within the concept of property immovable by their nature.

Whereas rent is VAT-exempt according to the general rule, a VAT payer is entitled to opt for taxation, ie, VAT can be charged on rent of the property if the customer is registered for VAT purposes and performs business activities. From 2012, VAT may be charged on rent of real estate to legal persons established under diplomatic and consular arrangements or to institutions of the EU, the EIB, and the ECB, even if these legal persons are neither VAT-registered nor do they perform business activities. If a company exercises this right in respect of one rent transaction, the same VAT treatment will automatically apply to all analogous transactions for the following 24 months.

Legal aspects

Lease of real estate property has to be concluded in written form. Such lease may be invoked against third parties only if it is registered in Real Estate Register. The rights to use the land plot which is occupied by the buildings shall pass to the lessee simultaneously with the transfer of buildings. The parties may freely agree on lease terms, but in all circumstances, it cannot exceed 100 years. Fixed-term lease shall be considered to become indefinite if lessee continues to use the property for more than ten days after the expiry of the lease contract without any opposition from the property owner.

The lessee who has duly performed his obligations under the contact will have a preferential right to renew the contract on the same conditions it is offered to third parties. Property owner must inform lessee about his right to renew the contract. In case property owner violates his duty to renew the contract, lessee may either request the transfer of the rights of the lessee under the new contract or claim for compensation of damages incurred. The parties may freely agree on terms and conditions of payment of lease and other expenses. Payment for the leased

property from the State is calculated on fixed tariffs. Commercial rent also may be evaluated as a percentage of the lessee's turnover (for example, lease of space in shopping centres). In such cases minimum fixed payment should also be established. Lease payment may also be established by certain services to the property owner or by the duty of lessee to improve leased property on his own expense.

When transferring the rights of ownership, leased contracts, registered in the Real Estate Register, shall preserve validity to the new owner. It is important to note, that transfer of the right of ownership gives a right to the lessee to terminate the lease contract.

If property owner seeks to evict lessee from the leased property, he should apply to the court. Lease of agricultural land from the State is limited to 25 years. It is usually leased through public auctions, unless the lessee falls in few specified categories by law (such as, when a person owns a building on a leased land plot or land plot is embedded between other leased land plots, or the land will be used for a public-private partnership project, etc). For such lease, the confirmation from the regional National Land Service is needed.

Constructions

Legal aspects

All constructions shall be implemented following and subject to territorial planning documents and construction procedures established by the law. Before the constructions works take place, it is usually required to prepare a detailed plan (or other territorial planning document) of the construction site and the land plot. Such document plan determines the essential construction parameters in the land plot: maximum allowed height of buildings, construction intensity, security zones, land boundaries, land management and operating modes and other aspects.

In certain cases, for more hazardous or dangerous activities, it may be required to perform environmental impact assessment, eg, if the construction is near protected territories.

In order to obtain a construction permit, a set of design conditions for constructions works have to be obtained. The set of design conditions includes conditions on connection to networks supplying water, gas, electricity, heating and telecommunications. After approval of the set of design conditions, design of building in accordance with the design conditions has to be prepared.

Construction permit shall be issued in about 15 to 25 business days from the submission of all necessary documents to the Building Permits and State Construction Supervision Information System (*infostatyba*), depending on the complexity of the building (eg, in case the term is not extended due to additional requests). Issued construction permit is valid indefinitely.

Works to destroy a building require a demolition permit unless are covered by construction permit.

Operating real estate

Tax depreciation

The depreciation of buildings and other structures is calculated separately for each asset. Generally, buildings may be depreciated over periods from 8 to 20 years. New buildings may be depreciated using either a straight-line or double declining balance method. All other buildings may be depreciated using only the straight-line method. The method selected should be applied consistently: the same depreciation method selected by the entity shall be applied to every class of fixed assets and each item of assets within that class over the total depreciation or amortisation period for fixed assets.

If an entity acquires fixed assets and places them in service during the first half of the year, depreciation of such assets is commenced during the same year. If an entity acquires fixed assets and places them in service during the second half of the year, depreciation is commenced during the year immediately following that year in which the assets had been acquired and were placed in service. An entity also may choose to calculate the depreciation of all fixed assets from the first day of the next month after such assets were put into use by using the straight-line method.

Loss carryforward

Operating tax losses can be carried forward for an unlimited period of time as long as activities from which the losses were accumulated are continued. The losses incurred from disposal of securities or derivative financial instruments can be carried forward for a period of five years starting from the year after such losses were incurred

and can only be offset against income of the same nature. Only up to 70% of current year's taxable profits can be offset against tax losses carried forward.

Upon the merger, the tax losses of the merged companies can be carried forward provided that the same activities are continued to be carried on for at least three years after the merger.

Intra-group transfer of tax losses

Tax losses can be transferred from one company to another within the same group of companies if certain conditions are met.

Real estate tax (RET)

RET applies on buildings/premises owned by companies and individuals. The RET rate may vary from 0.5% to 3% depending on municipalities.

In Vilnius city municipality, the RET rates established for 2020 are:

- 1% standard RET rate;
- 0.7% for cultural, leisure, catering, sport, educational or hotel buildings (with some exceptions);
- 3% for premises and structures, the owners or users of which do not perform the duties of users while supervising the structure, for actually used real estate, that is not 100% completed and for real estate that is not used at all or is abandoned or unattended.

Residential and other personal premises (eg, garden, garages, farms, greenhouses, auxiliary farms, science, religious, recreational buildings (premises), fishery buildings and engineering structures) owned by individuals are exempt from tax where the total value of 150,000 EUR is not exceeded, whereas the excess value is subject to progressive taxation at the following RET rates:

Total taxable value (in euro)	**RET rate (in %)**
Up to 150,000	0
Between 150,000 and 300,000	0.5
Between 300,000 and 500,000	1
More than 500 billion	2

Residential and other personal premises (eg, garden, garages, farms, greenhouses, auxiliary farms, science, religious, recreational buildings (premises), fishery buildings and engineering structures) held by individuals which meet certain criteria (raising three or more children (adopted) under the age of 18 and raising a disabled child (adopted) under the age of 18, as well as an elderly disabled child (adopted) with a special need for permanent care) are exempt from tax where the total value of 200,000 EUR is not exceeded, while the excess value is subject to progressive taxation at the following RET rates:

Total taxable value (in euro)	**RET rate (in %)**
Up to 200,000	0
Between 200,000 and 390,000	0.5
Between 390,000 and 650,000	1
More than 650 billion	2

Tax base is the average market value of the property. Depending on the type and purpose of the property, it can be assessed either by mass valuation method (performed every five years) or using the replacement value (costs) method. There is a possibility to apply the property value determined during the individual valuation if it differs from the tax base value by more than 20%.

Land tax

Land tax applies on land owned by companies and individuals (Lithuanian and foreign), except for the forest land.

Land tax rates range from 0.01% to 4% depending on local municipalities. In Vilnius city municipality, the land tax rates established for 2020 are:

- 4% tax rate for the land that is not used and for the land with buildings recognised as unauthorised construction;
- 0.12% for any other land (eg, owned by individuals or companies).

Exemption from land tax is available in some cases. The tax base is the average market value determined by the State Enterprise Centre of Registers according to the mass valuation performed not rarer than every five years (typically, the value is much lower than the actual market price of land). However, there is a possibility to apply the property value determined during the individual valuation if it differs from the tax base value by more than 20%.

State-owned land lease tax

Lithuanian and foreign companies which use state-owned land for their economic activities are subject to land lease tax. The minimum tax rate is 0.1% and the maximum tax rate is 4% of the value of the land. The actual rate is established by the relevant municipality council. In Vilnius city municipality, the land lease tax rate for 2020 varies from 0.5% to 4%.

Inheritance tax

Inheritance tax is levied on a beneficiary. Property for inheritance tax purposes is defined as real estate and movable property as well as securities, cash, etc. Foreigners pay this tax in the same manner as citizens of Lithuania, however, only inherited real estate and movable property subject to registration in Lithuania is subject to taxation. The base of the inheritance tax is calculated taking 70% of value of the inherited property and subtracting received amount by 3,000 EUR (non-taxable amount). The rate of the inheritance tax depends on the tax value of the inherited property: 5% (if the taxable value is up to 150,000 EUR) and 10% (if the taxable value exceeds 150,000 EUR).

Inheritance tax is not imposed if the taxable value of the inherited property does not exceed 3,000 EUR, also when the property is inherited by the remaining spouse following the death of one's spouse, children (adopted children), parents (foster parents), guardians (custodians), a child in custody, grandparents, grandchildren, brothers or sisters.

Gift taxation

There is no separate gift tax applicable in Lithuania – the gifts received by individuals are subject to personal income taxation. Income received as gift from spouses, children (adopted children), parents (foster parents) brothers, sisters, grandchildren and grandparents, as well as income not exceeding 2,500 EUR during the calendar year received as a gift from other individuals is non-taxable.

Financing the property

Debt

Thin capitalisation

Lithuanian thin capitalisation rules apply with respect to Lithuanian entities with debt to either Lithuanian or foreign controlling parties (hereinafter “the controlled debt”).

A controlling party is a controlling taxable person or resident (Lithuanian or foreign) who controls a Lithuanian entity on the last day of a tax period and, directly or indirectly, owns more than 50% of shares (or together with other related parties own more than 50% of shares of the Lithuanian entity whereas not less than 10% of shares are controlled by the controlling party). A controlling party also include other entities within the same group.

Controlled debt is the debt, which a Lithuanian entity borrows from controlling parties, including debt from third parties if those debts are guaranteed by the controlling party, and debts guaranteed by the third parties to a Lithuanian entity if the controlling party guaranteed such debt for those parties.

If the controlled debt-to-equity ratio of a Lithuanian entity exceeds 4:1, the interest expenses on the controlled debt exceeding the ratio are deemed to be non-deductible for profits tax purposes.

This provision will not apply if a company can substantiate that the same loan would be provided under the same terms and conditions between independent (not related) persons.

The 4:1 ratio is calculated on the last day of the tax period.

According to the Lithuanian thin capitalisation rules, interest expenses on profit participating loans and profit related rental expenses are recognised as not related to earning of income, therefore, cannot be recognised as deductible expenses for profit tax purposes.

Interest deductibility rules

Following the EU Anti-Tax Avoidance Directive (EU ATAD), as of 1 January 2019, a new interest limitation rule has been introduced. An entity is given the right to deduct interest costs exceeding interest revenue up to 30% of taxable EBITDA or up to 3 million EUR.

Exceeding borrowing costs are calculated as the amount by which the borrowing costs of a taxpayer exceed interest revenues (ie, interest income minus interest expenses). Interest includes interest on all forms of debt (from related as well unrelated parties), including but not limited to:

- payments under profit participating loans;
- notional interest amounts under derivative instruments or hedging arrangements related to an entity's borrowings;
- foreign exchange gains and losses on borrowings and instruments connected with the raising of finance;
- guarantee fees for financing arrangements;
- other costs/income economically equivalent to interest and incurred in connection with the raising of finance.

If an entity belongs to the group of entities, the above criteria shall be applied jointly for all Lithuanian entities and PEs of foreign entities in Lithuania that belong to the same group. Restrictions do not apply if an entity's financial results are included in the consolidated financial results of a group, and the equity-to-asset ratio of that entity is not more than 2 percentage points lower than the equivalent ratio of the group.

Interest costs exceeding interest revenue could be carried forward without time limitation. The mentioned rules do not apply to financial institutions and insurance companies.

Transfer pricing rules

All transactions between associated parties must be performed at “arm’s length”. The Tax Authority has a right to adjust transaction prices if they do not conform to market prices.

The Lithuanian transfer pricing rules refer to the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations prepared by the OECD to the extent that they do not contradict with the domestic rules.

All companies with annual revenue exceeding 3 million EUR, as well as all banks, insurance companies and credit institutions are required to prepare transfer pricing documentation in a specifically prescribed form. A Master File is mandatory if an entity belongs to the international group of companies and its previous period’s revenue in Lithuania exceeds 15 million EUR. As from 1 January 2019, general managers of companies that fail to comply with the above-mentioned requirement for the transfer pricing documentation may be subject to a penalty ranging from 1,800 EUR to 6,000 EUR.

Withholding tax

Certain income sourced in Lithuania and received by a foreign entity otherwise than through its PEs in Lithuania is subject to WHT.

Interest paid from Lithuanian companies to foreign companies established in the EEA or in countries with which Lithuania has a DTT is not subject to WHT in Lithuania. Otherwise, interest sourced in Lithuania and received by a foreign company is generally subject to WHT at the rate of 10%.

Tax grouping

Group taxation legislation and regimes are not available in Lithuania. Each Lithuanian entity is regarded as a separate taxpayer and may not deduct tax losses accumulated from previous tax periods at the level of any other group entity.

Transfer of current year operating tax losses incurred to an entity of the same group of companies is allowed if certain requirements are met.

Equity financing

In Lithuania no capital duty is applicable.

Anti-avoidance rules

In addition to above mentioned, Lithuania also has specific anti-avoidance rules (part of them implementing EU ATAD), including:

- rules on taxation of controlled foreign companies (CFC rules);
- rules on taxation of dividends receivable/payable from/to foreign companies;
- substance over the form principle;
- rules on taxation of hybrid mismatches;
- exit taxation;
- general anti-abuse rule (GAAR).

Implementation of base erosion and profit shifting (BEPS) provisions

The OECD has announced a package of BEPS recommendations aiming to increase transparency of international taxation and prevent tax evasion and aggressive tax planning. Many OECD countries, as well as Lithuania, have already started shifting certain provisions related to implementation of the BEPS recommendation package into their tax legislation.

Lithuania signed the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Instrument", or MLI) and deposited its instrument of ratification on 11 September 2018. The Multilateral Instrument entered into force on 1 January 2019 for Lithuania.

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Real Estate Going Global

Luxembourg

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 August 2020.

Real Estate Tax Summary

General

Luxembourg has been a favoured place for real estate ownership structuring for nearly two decades. The main principles of Luxembourg tax law are an important factor in allowing investors to structure real estate investments or reorganisations in the most efficient way.

The purpose of this summary is not to give an exhaustive description of the Luxembourg tax and regulatory system as it applies to real estate, but to give an overview of the main Luxembourg tax and regulatory aspects of investing in real estate in or through Luxembourg.

Taxation of individuals

Luxembourg resident taxpayers are subject to personal income tax on their worldwide income. Non-resident taxpayers are taxed only on their Luxembourg-sourced income, notably on income derived from real estate located in Luxembourg. In general, international tax treaties concluded by Luxembourg also give the right to tax income derived from Luxembourg real estate property to Luxembourg (in line with Article 6 of the OECD Model Convention). The personal income tax rates are progressive and for 2020, range from 8% up to 42%. A 7% or 9% surcharge for contribution to the unemployment fund applies on the income tax due. For individual resident taxpayers in Luxembourg, an additional contribution called "*assurance dépendance*" (1.4%) is due on income derived from property.

Taxation of business undertakings

In Luxembourg, some business undertakings (ie, operated through partnerships) are subject to personal income tax on profits. However, the majority of businesses are operated through joint-stock companies and are subject to corporate income tax (CIT).

Taxation of business undertakings realised by a resident company

Corporate income tax

Luxembourg taxes its corporate residents on their worldwide income and non-residents only on Luxembourg-source income. Businesses with taxable income lower than 175,000 EUR are subject to CIT at the rate of 15%. Businesses with taxable income between 175,000 EUR and 200,001 EUR are subject to CIT computed as follows: 26,250 EUR plus 31% of the tax base above 175,000 EUR (for the fiscal year [FY] 2020). The CIT rate is 17% for companies with taxable income in excess of 200,001 EUR leading to an overall tax rate of 24.94% in Luxembourg City for FY 2020 (considering the solidarity surtax of 7% on the CIT rate, and including the 6.75% municipal business tax rate applicable).

The Luxembourg tax law provides that certain types of income (notably dividends, capital gains and liquidation proceeds) may be exempt from taxation under certain conditions.

Municipal business tax

Municipal business tax is levied by the communes and varies from municipality to municipality. Municipal business tax is assessed annually at the rate of 6.75% (for Luxembourg City) on the operating profit and is generally calculated on the taxable income as computed under the CIT rules. Consequently, any exemption under the CIT rules should generally result in a de facto exemption under the municipal business tax rules. Moreover, a flat allowance of 17,500 EUR is available.

Net wealth tax

Luxembourg companies are subject to net wealth tax (NWT). The basis for this annual tax is the market value of the net operating assets, set by the unitary value of the company. Under the net wealth tax regime, the date at

which the net operating assets are assessed is the 1st January of each financial year. The NWT charge is calculated on a digressive scale as follows:

- 0.5% on a taxable base of up to 500 million EUR;
- on a taxable base exceeding 500 million EUR: NWT of 2.5 million EUR, plus 0.05% on the component of the NWT base above 500 million EUR;
- no cap is set.

The Luxembourg tax law provides that certain shareholdings may be excluded from the net operating assets under certain conditions. Treaty exempt real estate assets are exempt from the basis as well.

Luxembourg levies a minimum NWT charge for all corporate entities having their statutory seat or central administration in Luxembourg. Entities whose sum of their financial assets, transferable securities and cash at bank exceeds 90% of their total gross assets and 350,000 EUR are subject to a minimum NWT charge of 4,815 EUR. All other corporations having their statutory seats or central administration in Luxembourg are subject to a minimum NWT charge ranging from 535 EUR to 32,100 EUR depending on the total gross assets showing in the tax balance sheet.

Foreign real estate assets might be exempt from the calculation ratio for the minimum NWT.

Withholding tax

Under the current domestic law, there is no withholding tax (WHT) levied on “arm’s length” interest payments, and on liquidation proceeds distributions.

The European Union (EU) Savings Directive, which exceptionally applied a WHT, is no longer applicable, as it has been repealed on 10 November 2015. Instead, Luxembourg has implemented the Foreign Account Tax Compliance Act (FATCA) an the OCED Common Reporting Standard (CRS).

On 28 March 2014, Luxembourg concluded a Model 1 Intergovernmental Agreement (IGA) with the United States of America (USA/US) regarding the implementation of FATCA. The IGA was ratified by the Law of 24 July 2015 (the “FATCA Law”). This Law aims to detect US tax evasion and requires Luxembourg financial institutions (FIs) to identify and document all direct (and under certain circumstances indirect) US clients/investors. In addition, on an annual basis, Luxembourg reporting FIs must report certain information (incl. financial information such as account balance, income and gross proceeds) about these US clients to the Luxembourg tax authorities that will exchange this information with the US tax authorities (Internal Revenue Service, or IRS). Foreign FIs, which do not comply with the regulations, might face the 30% WHT on US-sourced income for payments made on or after 1 July 2014 regardless if they have US clients/investors or not.

The CRS has been incorporated in the amended EU Directive on Administrative Cooperation as regards mandatory automatic exchange of information (AEOI) in the field of taxation (DAC 2) officially adopted by the European Council on 9 December 2014. On 24 December 2015, the Luxembourg CRS Law of 18 December 2015 was published, implementing CRS into Luxembourg law (the “CRS Law”). CRS entered into force in Luxembourg as from 1 January 2016. The CRS Law requires Luxembourg FIs to review and collect information to identify the CRS status and/or the country of tax residence of their clients/investors (and their controlling persons, if applicable). Similar to FATCA, Luxembourg reporting FIs need to report certain information about reportable clients/investors on an annual basis to the Luxembourg tax authorities that will exchange this information with the foreign tax authorities.

Each entity should analyse its FATCA and CRS status to assess its related FATCA and CRS obligations. Upon request of counterparties, self-certification forms might need to be completed in order to disclose the status for FATCA and CRS purposes. In addition, the Luxembourg Law of 18 June 2020 modifying the Luxembourg FATCA Law and the Luxembourg CRS Law requires Luxembourg reporting FIs to establish a compliance framework (including procedures and adequate systems and internal controls).

The domestic rate of 15% generally applies to dividend distributions. This rate can, however, be reduced/eliminated by exemption given under domestic legislation, by the application of a double tax treaty (DTT), or by application of the EU Parent-Subsidiary Directive as transposed into the Luxembourg domestic tax law.

Under the Luxembourg law, dividend distributions are exempt from WHT in Luxembourg if all the following conditions are fulfilled:

- The distributing company is a fully taxable Luxembourg joint-stock company.
- The company receiving the dividends is:
  - another fully taxable Luxembourg joint-stock company;

- a company resident in an EU Member State and falling under Article 2 of the Council Directive 2011/96/UE dated 30 November 2011, on the common system of taxation applicable in the case of parent companies and subsidiaries of different Member States (EU Parent-Subsidiary Directive);
- a Luxembourg permanent establishment (PE) of a company resident in an EU Member State and falling under Article 2 of the foregoing Directive;
- a Luxembourg PE of a joint-stock company resident in a state with which Luxembourg has concluded a DTT; or
- a collective entity subject to a tax corresponding to the Luxembourg CIT (ie, a tax rate of minimum 8.5% assessed on a similar basis as in Luxembourg) and is a resident in a state with which Luxembourg has concluded a DTT.

- At the date on which the income is made available, the beneficiary has been holding or undertakes to hold, directly, for an uninterrupted period of at least 12 months, a participation of at least 10% or with an acquisition price of at least 1.2 million EUR in the share capital of the payer. If the participation is held through a Luxembourg tax transparent entity, this will be regarded as a direct participation, proportionally to the interest held in the tax transparent entity.

The European general anti-avoidance provision, amending the participation exemption regime under the EU Parent-Subsidiary Directive, has been effectively incorporated into Luxembourg law. The provision precludes the Directive benefits, in situations where there are arrangements, which have been put into place for the main purpose or one of main purposes of obtaining a tax advantage that defeats the object or purpose of the Directive and are not genuine, having regard to all relevant facts and circumstances. This entails that for the purpose of this rule, an arrangement must be regarded as not genuine insofar as it has not been put into place for valid commercial reasons, which reflect economic reality.

According to this rule, the exemption from Luxembourg WHT might no longer apply to distributions made to a corporate entity in another EU Member State under the above condition, even if the recipient of dividends were formally regarded as qualifying for this specific exemption. Going forward, the eligibility to domestic WHT exemption should be carefully analysed on a case-by-case basis.

Transfer pricing

Transfer pricing Circular

On 27 December 2016, the Luxembourg tax authorities issued a transfer pricing Circular in relation to corporations that are engaged in intra-group on-lending activities financed by borrowings, on the basis of the Article 56bis Luxembourg Income Tax Law (LITL) which is providing general transfer pricing rules.

The Circular explicitly brings some of the key principles set out in the OECD Guidelines in their 2017 form (ie, the requirement for comparability analysis that looks at functions, risks and contractual terms) into the LITL.

This Circular is reinforcing the principles already highlighted in the 2011 Circulars (no longer applicable), where Luxembourg companies should be in a position to demonstrate sound and appropriate levels of economic and operational substance and beneficial ownership. Both of these are attributes are of growing importance in a global fiscal environment that increasingly focuses on tax treatments that are congruent with the underlying business economics.

There are two main new requirements that have been strengthened in the Circular:

- Substance: sufficiently qualified personnel in Luxembourg to bear and control the risks associated to the financing activities;
- Equity: equity at risk to be evaluated based on the credit risk of the borrower/corporation.

In addition to the two main requirements, the Circular provides for the following key changes:

- “arm’s length” remuneration;
- commercial rationale; and
- substance over form;

Companies falling in the scope of the Circular that do not comply with the substance and/or equity requirements, may be subject to exchange of information.

The transfer pricing Circular is applicable since 1 January 2017.

OECD’s Chapter X

On 11 February 2020 the OECD issued its final report on “*Transfer Pricing Guidance on Financial Transactions*”.

The report addresses general guidance to the application of the “arm’s length” principle, as well as specific issues relevant to treasury functions (ie, intra-group financing, cash pool structures, and hedging), issues linked to financial guarantees, and captive insurance and reinsurance arrangements.

Transfer pricing (TP) documentation currently in place to support the “arm’s length” nature of existing intra-group financing transactions should be carefully reviewed, as it may be a good time to reconsider such analysis in the light of the clarifications conveyed in new Chapter X of the OECD TP Guidelines.

COVID-19

The economic developments derived from the COVID-19 crisis are expected to have an impact on the determination of intra-group arrangements. Some of the anticipated effects of COVID-19 on intra-group financial transactions are listed below:

- Intra-group financing: Increasing interest rates applied throughout intra-group financing dealings (eg, loans, cash pooling arrangements) in comparison with the pre-confinement period. There are many factors to consider in this respect, such as a limited and more expensive capital markets and lower credit ratings.
- Financial guarantees: Intra-group financial guarantees may be put in place to mitigate the impact of the financial crisis, as it may provide the required support to extend credit lines, increase borrowing capacity and improved financing conditions, such as better lending terms and lower interest rates.
- Captive insurance: Expected increase of captive insurance due to the increased cost of external re-insurance due to the COVID-19 crisis.
- Hedging: Current market volatility may impact expected conditions and risks related to financial transactions (eg, issuance of public debt), which may increase the complexity for hedging such transactions.

Sustainability

In the current economic context, sustainability is becoming a key element when developing business strategies and improving companies’ competitive advantage. The Luxembourg Government has developed and offered different types of aid schemes and tax incentives to encourage Luxembourg based companies to be more sustainable.

Taxation of business undertakings realised by a non-resident company

A foreign company may be subject to tax in Luxembourg if it conducts commercial activities in Luxembourg through a PE, or (in the absence of such a PE) on income which has a strong attachment to Luxembourg (eg, income from immovable property located in Luxembourg). It should be noted that, under certain conditions, speculative capital gains resulting from the sale of shares in a Luxembourg company by a non-resident company may be taxable in Luxembourg, although this taxation is relatively limited in scope. In addition, there may be DTTs concluded between the state of residence of the foreign shareholder and Luxembourg that preclude this capital gains tax charge.

Indirect taxes

Value-added tax (VAT)

General principles

The normal VAT rate in Luxembourg is 17%. However, under some conditions, the “super-reduced rate” of 3% can apply to qualifying building renovation works of housing when the housing is used as a main residence. The rate is also applicable to the construction of housing if it is used as a main residence by the owner. The application of this super-reduced rate is limited to certain types of works.

Any person letting or leasing immovable property qualifies as VAT taxable person. Depending on whether the letting/leasing is VAT taxable or VAT exempt, the taxpayer will have different VAT compliance obligations.

Place of taxation

Supplies of services

As a general rule, the place of taxation of supplies of services depends on the VAT status of the recipient. Services rendered to non-taxable persons (B2C) are generally deemed to be taxable in the country of establishment of the supplier, with some exceptions. Services rendered to taxable persons and assimilated persons (B2B) are generally

deemed to be taxable in the country where the customer/recipient has established his business, with some exceptions.

The main exception in the real estate sector concerns services connected with immovable property. Such services are deemed to be taxable in the country where the immovable property concerned is located, regardless of the VAT status of the service recipient.

Supplies of goods

The rules for determining the place of taxation of supplies of goods depends on several factors, such as whether the goods are transported or not and whether the supply of the goods occurs with installation. As a result, the supply of an item of real estate is deemed to be taxable in the country where such immovable property is located.

VAT exemption

According to the Luxembourg VAT Law, the sale, letting and leasing of immovable property is generally exempt from VAT. This exemption is not applicable to the transfer of ownership of a not yet existing building, work on existing buildings (renovations), the provision of accommodation in hotels and camping areas, the letting of equipped sites for the off road parking of vehicles, the letting of machines, tools, and business installations, and the hire of safes.

In case of the supply of a building which is partially built, it is necessary to distinguish between the part already built and the part still to be built, because different VAT treatments apply (ie, partially exempt and partially subject to VAT).

Option to VAT

Under certain conditions, the parties to a sale, letting or leasing of immovable property located in Luxembourg may opt for VAT.

The advantage of an option to tax resides in the fact that it preserves VAT neutrality. A seller/landlord undertaking a real estate based transaction subject to VAT is allowed to deduct input VAT it incurs in relation with that transaction (eg, VAT on the construction, the acquisition or the refurbishing of the building).

Input VAT recovery right

VATable persons performing VATable operations can recover input VAT incurred on the purchase of goods and services which are in direct and immediate link with such operations. VAT incurred on costs linked to the VAT exempt sale, leasing or letting of an immovable property is not recoverable, but a final cost for the taxpayer.

VAT adjustments over a ten-year period

VAT incurred on the purchase or development/construction of immovable property is subject to adjustments over a ten-year period, either in favour of the VAT authorities or the taxpayer, if the use of the immovable property (ie, VAT taxable or VAT exempt) changes over this period.

The same applies for renovation works.

Registration duty

Transactions involving the transfer of immovable property are subject to registration duty (*droit d'enregistrement*) in Luxembourg. This is levied on the value of the land and of the parts that are already built.

Registration duties are also levied on the registered rent of immovable property located in Luxembourg if the rental agreement is submitted for registration to the *Administration de l'Enregistrement, des Domaines et de la TVA*. The rates of registration duties are either fixed or progressive. Further details are set out below. Since October 2016, the registration of rental agreements is no longer mandatory.

A fixed registration duty of 75 EUR is due upon incorporation (and on any capital increase or amendment to the article of association) of any Luxembourg resident company (including an SCI), or Luxembourg fund vehicles (including SIFs, SICARs and securitisation vehicles).

Real Estate Investments

Preface

The real estate industry is currently facing a multitude of challenges and transformations while being in a period of uncertainty. Nevertheless, Luxembourg remains an attractive location for real estate investment or real estate ownership structuring. Although Luxembourg has been affected by the crisis, along with its European partners, its political, social, legal and fiscal stability has enabled Luxembourg to remain competitive.

On 12 July 2013, the Luxembourg legislator transposed the Alternative Investment Fund Manager Directive (AIFMD) into domestic law and used this opportunity to introduce a new form of limited partnership very similar to the well-known English limited partnership. The new legal framework also provides the flexibility to have this Luxembourg limited partnership being regulated or not.

On 25 May 2018, the Economic and Financial Affairs Council (ECOFIN) formally adopted the Council Directive amending Directive 2011/16/EU (commonly referred as "DAC 6"), which implements new transparency rules that should be applicable for intermediaries – such as tax advisors, accountants, banks and lawyers – who design, market, organise, make available for implementation, or manage the implementation of cross-border structures for their clients or who provide aid, assistance or advice in relation to these services. The aim of DAC 6 is for intermediaries or relevant taxpayers to disclose potentially aggressive tax planning arrangements. On 8 August 2019, the Luxembourg Government tabled a bill (No 7465) before the Luxembourg Parliament setting out draft legislation transposing the DAC 6 into domestic law. The final bill was voted on 25 March 2020. DAC 6 is applicable in Luxembourg as from 1 July 2020.

On 19 June 2018, the Luxembourg Government tabled a draft bill before the Luxembourg Parliament that should implement the EU Anti-Tax Avoidance Directive (ATAD I) into the Luxembourg domestic law. The ATAD I impacts the interest limitation rules, the controlled foreign company (CFC) rules, the intra-EU anti-hybrid rule and the general anti-abuse rule (GAAR). ATAD I was implemented in Luxembourg by the law of 21 December 2018 and applicable to tax years starting on or after 1 January 2019.

Council Directive (EU) 2017/952 of 29 May 2017 amending Directive EU/2016/1164 ("ATAD II") extends the hybrid mismatch definition of ATAD I (which covered situations involving double deductions or deduction without a corresponding inclusion in the taxable basis as a result of the hybrid nature of the relevant entities or hybrid financial instruments) to include notably mismatches resulting from arrangements involving PEs, hybrid transfers, imported mismatches, reverse hybrid entities and tax residency mismatches. ATAD II also extends the hybrid mismatches with non-EU countries.

On 8 August 2019, the Luxembourg Government tabled a bill before the Luxembourg Parliament aiming at transposing ATAD II into domestic law. The bill set out a detailed commentary (the "Commentary") which in places gives guidance on how ATAD II rules, as implemented in Luxembourg, may be interpreted. On 19 December 2019, the Luxembourg Parliament voted to approve the law implementing ATAD II into Luxembourg domestic law. ATAD II Law applies as from 1 January 2020. As from the 2022 tax year, the scope is also extended to Luxembourg entities that are regarded under Article 175 LITL as being tax transparent for Luxembourg tax purposes, effectively, in some cases, turning such entities into Luxembourg taxpayers for CIT for all or part of their income.

Direct investments in real estate

Legal aspects

The right of ownership

Under Luxembourg law, the right of ownership is defined as the right to enjoy and dispose of assets in the most absolute way, provided that no use is made thereof that is prohibited, or which might jeopardise the rights of third parties.

Attached to the right of ownership is the right of accession. On one hand, by virtue of the right of ownership, the owner of property is presumed to be the owner of the ground and of the subsoil, unless otherwise stated to the contrary. On the other hand, the right of accession is also regarded as being a way to acquire ownership of things

related to the land. Thus, ownership of the land includes ownership of all the proceeds and income deriving therefrom as well as ownership of all that is attached to it.

By agreement, rights in rem can be granted to persons other than the owner of the land, by concluding a long lease, constituting a building right, or granting a usufruct.

Sales agreement, pre-contractual agreement, notarial deed and registration

The purchase of property is made by concluding a sales agreement governed by both the law of contract in general and the specific rules applicable to sales.

A sales agreement is concluded at the moment that there is mutual consent between vendor and purchaser as to the identity of the asset to be sold, even if that asset does not yet exist (the transfer of ownership then being deferred) and as to the price. The price must be either already fixed, or determinable by reference to factors that are independent of the will of the parties. Oral sales contracts are possible, as a written contract is not necessary for the sale to bind the parties.

However, a sale of real estate must be registered, an act which triggers the payment of registration taxes, and recorded in the mortgage registry in order to be enforceable vis-à-vis third parties. As only duly certified deeds may be entered in the register, the sale must be recorded in a notarial deed. It is the notary public who will present the notarial deed for recording in the register.

Long leases, building rights and usufruct

Long leases, building rights and usufruct are rights in rem that derive from the ownership of property. For the lessee, these rights normally confer more stability than a mere rental agreement as well as more extensive rights, and the lessor is guaranteed income over a longer period.

Long leases

A long lease (*droit d'emphytéose*) allows the holder to use and enjoy property belonging to a third party in consideration for a yearly payment made in cash or in kind. The long lease must be granted for a fixed period of time varying between 27 and 99 years, a term which is renewable. The minimum period of the lease is increased to 50 years in the case of housing property.

By virtue of such a lease, the holder may exercise all the rights attaching to the property but is not permitted to reduce the value of the property. The leaseholder must, however, be able to freely transfer his right to any third party, without the prior consent of the owner. The leaseholder may also grant a mortgage over the lease, the duration of which may not be longer than the term of the lease itself.

The leaseholder has to pay all expenses and taxes relating to the buildings and plantings, whether or not erected by the leaseholder, that are located on the property.

At the expiration of the long lease, the lessor becomes the owner of all buildings and plantings located on the land. Unless otherwise provided for under the lease, the holder will not be entitled to compensation for buildings the holder has erected or any plantings the holder has made.

The parties can also freely determine their respective obligations by agreement, except for the duration of the long lease right.

A long lease is constituted and transferred like a right of ownership, by a deed signed before a notary public that is subsequently recorded and entered in the mortgages register.

The leaseholder also has a right of first refusal to purchase the property.

Building rights

A building right (*droit de superficie*) is a right in rem granted for a fixed duration of a maximum of 99 years, a term which is renewable, which allows the holder to own and erect buildings, works or plantings on a property belonging to another. The holder may grant securities or rights of usufruct over the building right or transfer it to third parties.

For the duration of the contract, ownership of the land and ownership of the buildings thereon are distinct. Upon the expiration of the building right, the owner of the land becomes the owner of all the buildings and plantings located thereon by virtue of the right of accession. However, the owner of the land has to pay compensation to the holder of the building rights for all buildings constructed and plantings done.

Under certain circumstances, this compensation is not payable to the right-holder for constructions that already existed when the building right was constituted.

In the capacity as the owner, the holder has to bear all expenses and taxes relating to the buildings and plantings located on the land.

The parties can also freely determine their respective obligations by agreement, except for the duration of the building right. Building rights are constituted and transferred as in the case of rights of ownership by a deed signed before a notary, which is subsequently registered, and entered in the mortgages register.

The holder of the building right also has a right of first refusal to purchase the property.

Usufruct

Usufruct allows a renter temporary enjoyment of a property belonging to another. If granted to an individual, the usufruct generally can only be terminated upon the occurrence of a certain event and its term may not exceed the lifetime of the renter. If granted to a corporate body a usufruct is limited to 30 years.

Unless expressly forbidden by law or by the deed constituting the usufruct, the renter may transfer its right to a third party. Even if transferred, the usufruct will terminate upon the death of the initial renter. The renter may also grant a mortgage over its right, the duration of which cannot exceed the lifetime of the initial renter.

The main obligation of the renter is to take good care of the property. The renter has to insure and maintain the property in good order and is responsible only for minor repairs. The remainderman has to pay for all major repairs, for instance, roof repairs. Except if expressly discharged by the remainderman, the renter has to put up a guarantee for the performance of the renter's obligations.

The renter is entitled to receive all proceeds and income deriving from the subjects of the usufruct but, against this, has to bear all annual expenses incurred in connection with such proceeds and income.

At the end of the usufruct, the renter is not entitled to compensation for any improvements the renter has carried out.

A property usufruct is constituted by notarial deed, which is subsequently registered and entered in the mortgages register.

Tax aspects

Direct investment in Luxembourg property by individuals

Whatever the status of an owner of a property located in Luxembourg, ie, private individual resident or non-resident taxpayer, the taxable basis of income derived from the property will be determined in accordance with Luxembourg law.

Resident individuals

Rental income

Any individual registered as tax resident in Luxembourg and investing in Luxembourg property is subject to personal income tax on income attributable to property located in Luxembourg.

Under Luxembourg tax law, rental income that is taxable includes the income from the actual rental of a building.

However, only the net amount of rental income derived from the property investment is subject to Luxembourg income tax and dependency contribution.

The tax rate for rental income is the recipient's marginal tax rate, which varies between 0% and 42% for 2020 (to which the surcharge for the unemployment fund contribution is added), depending on the taxpayer's overall level of income. The net rental income is also subject to the dependency contribution.

Determination of the net rental income derived from the actual rental

The net income is equal to the "arm's length" gross rental income less deductible expenses. Deductible expenses for rental income include inter alia the maintenance costs for the building, interest and charges linked to the financing of the property (we refer to the interest deduction limitation rules as applicable starting 1 January 2019, as described below), property taxes, insurance premiums, and depreciation of buildings.

Property is depreciable, with the exception of land. Regarding depreciation, if no split is made in the deed of sale between the price paid for the land and the price of the buildings, it is assumed that 20% represents the value of the land. The only method of depreciation for buildings is the straight-line method. The acquisition cost, including related expenses such as registration duties, the notary's and architect's fees, but excluding subsidies, forms the basis for depreciation. Depreciation rates are based on the useful life of the assets and vary between 2% and 6% per year.

Finally, the taxpayer can deduct a lump-sum amount for certain expenses (not including the debt interest on a loan used to acquire the property) in relation to the building, this amount being the lesser of 35% of the gross annual rentals or 2,700 EUR.

The income arising from the rental of housing to approved social organisations (eg, *Agence Immobilière Sociale*) benefit from a 50% exemption.

Determination of the net rental income derived from the owner-occupier

Only the "arm's length" interest paid on loan financing the acquisition of the property or the construction of an extension to the property is deductible with limits. Ceilings for the mortgage interest deductions related to the main residence are fixed at 2,000 EUR for the first year of occupation and the following five years, 1,500 EUR for the subsequent five years and 1,000 EUR for the following years.

Capital gains

Capital gains from the sale of the taxpayer's principal residence may generally be exempt from Luxembourg tax, subject to certain conditions.

Capital gains from the disposal of property, other than a principal residence, acquired less than two years prior to the sale of land and buildings, are taxable as miscellaneous income, or "*bénéfice de speculation*". The gain corresponds to the difference between the disposal proceeds and the acquisition price, without taking into account any deductions.

Capital gains on the disposal of property, other than the principal residence, held for more than two years are also taxable as miscellaneous income, but as "*bénéfice de cession*" ("long-term capital gain"). Such capital gains correspond to the difference between the re-valued acquisition price according to a revaluation factor determined annually, and the disposal proceeds, without taking into account any deduction. The acquisition price is the price paid by the previous buyer in case of transfer of real estate upon death. Moreover, in relation to long-term capital gains the taxpayer may benefit from a lump-sum deduction of 50,000 EUR for a single person or 100,000 EUR for married couple/partners taxable jointly. This allowance is available every ten years. To this deduction can be added a specific allowance of 75,000 EUR for sale of a main residence inherited from direct forbears. This specific allowance is available only once.

Under specific conditions, taxation of capital gains from the disposal of property can be deferred if it is used to fund the acquisition of a new property located in Luxembourg that the owner intends to rent out. For long-term capital gains (holding period of more than two years for immovable property), the acquisition price is adjusted by taking account of inflation coefficients.

Non-resident individuals

Rental income

Non-residents are taxable in Luxembourg on income arising from the rental of assets located in Luxembourg. The principles governing the taxation of rental income earned by residents are applicable to non-residents. If available, DTTs may avoid double taxation.

Capital gains

The same principles apply as for the taxation of capital gains realised by resident taxpayers. It should be noted that the lump-sum deduction of 50,000 EUR cannot be doubled in the hands of non-resident individuals who do not opt for a joint taxation.

Direct investment in Luxembourg property by a company

Resident companies

Companies resident in Luxembourg are subject to CIT and municipal business tax on their worldwide income. Taxable income of a company investing in a Luxembourg property comprises the total income realised on the property (that is rents plus capital gains on disposal), less allocable expenses. Allocable expenses include inter alia property tax, depreciation, maintenance, repair costs and interest on loans incurred in order to acquire the property.

The net income derived will be subject to CITand municipal business tax at the aggregate rate of 24.94% (for Luxembourg City) for 2020.

Property is depreciable, with the exception of land. Regarding depreciation, if no split is made in the deed of sale between the price paid for the land and the price of the buildings, it is assumed that 20% represents the value of the land. The only method of depreciation for buildings is the straight-line method. The acquisition cost, including related expenses such as registration duties, the notary's and architect's fees, but excluding subsidies, forms the basis for depreciation. Depreciation rates are based on the useful life of the assets and vary between 2% and 4% for a new building, or even more for older buildings. Industrial buildings are generally depreciated at 4%. Moreover, separate depreciation at a higher rate may be applicable for certain components of the property (ie, lifts or elevators, air-conditioning installations, etc).

The taxation of the capital gain resulting from the sale of property can be postponed provided the following conditions are satisfied:

- The asset transferred was in the balance sheet of the company for at least five years preceding the alienation.
- The new qualifying asset in which the company would reinvest is used in Luxembourg to ensure that any taxes due on the asset's final disposal are paid.
- The company keeps regular accounts.
- The reinvestment in a qualifying asset takes place before the end of the second year following the year of the sale. If the reinvestment does not take place in the year of sale, the tax charge may still be postponed provided that the company expresses its intention to reinvest the proceeds and the gain is entered as a special reserve in the balance sheet. If the conditions are not met, the gain must be added to taxable income.

Conversely to many other tax regimes, losses relating to the property can be used to offset any other taxable income. Tax losses incurred by a Luxembourg corporate taxpayer are available for offset against taxable profits arising in subsequent years. This carry-forward is for an unlimited period of time for losses incurred until FY 2016. Tax losses incurred as from FY 2017 may be carried for a maximum period of 17 years. Tax losses cannot be carried back in Luxembourg.

Resident partnerships

SCS and SCSp are tax transparent entities, and thus not themselves subject to Luxembourg CIT. As they are transparent, their partners are treated as carrying out, individually the activities of the SCS or SCSp. The activity of an SCS or SCSp may be subject to municipal business tax where:

- the general partner is a joint-stock company owning more than 5% of the interest in the SCS or SCSp, or;
- the activity of the SCS or SCSp is carrying on a "commercial activity" as defined in the LITL.

There are four criteria in Article 14 LITL for determining whether there is a commercial activity:

- The activity must be exercised in a permanent manner;
- The activity must be carried on in an independent manner;
- The activity must have a lucrative intention;
- The activity must be part of the general economic environment.

Insofar there are foreign partners, such business profits will only be taxed in Luxembourg, if they derive profits from a commercial activity as defined in the law and that such commercial activity is carried on through a PE.

In an administrative Circular, it was confirmed that AIFs in the legal form of an SCS or SCSp are deemed to exercise no commercial activity.

Non-resident companies

The taxation will vary depending on whether the non-resident company has a PE in Luxembourg.

Investment through a PE
Under the Luxembourg tax law, a PE is defined as any fixed piece of equipment, or any place that serves for the operation of an established business. Under domestic tax law, an independent commission agent would not cause a taxable presence, even if the activities fall under the definition of a PE. As a result, only a non-resident company that builds real estate in Luxembourg with the sole purpose of sale is taxable in Luxembourg on commercial revenue. Its revenue derived from the real estate property (rent and gains less allocable expenses) will be subject to CIT and municipal business tax at the aggregate rate of 24.94% (for Luxembourg City) for 2020.

Investment by a foreign company
In all other cases (ie, income earned by a non-resident company having no commercial activity in Luxembourg through a PE), the foreign company does not have a commercial activity, but will be subject to the Luxembourg taxation regime applicable to the nature of the Luxembourg-sourced income it receives.

In practice, the income from renting out a Luxembourg property is taxable as rental income under the same conditions as those for non-resident individuals (see section "*Direct investment in Luxembourg property by individuals*" above). Consequently, any tax losses incurred are not available for offset against taxable profits arising during subsequent years. However, as mentioned above, some expenses may be deducted from the gross rental income to establish the net income.

The capital gains on the real estate are taxable as miscellaneous income. The gain corresponds to the difference between the disposal proceeds and the acquisition price, without taking into account any deduction. For gains on assets owned for more than two years (ie, long-term gains), the acquisition cost may be re-valued using coefficients that are intended to account for the effect of inflation.

As outlined above, income from renting out a Luxembourg property and capital gains resulting from the sale of a Luxembourg property derived by foreign companies are subject only to Luxembourg CIT (including the surcharge for the unemployment fund) at the rate of 18.19% for 2020. It should be noted that the scope of this may also be affected by any applicable DTT.

Indirect taxes

VAT

As a general rule, the sale of an existing property located in Luxembourg is exempt from Luxembourg VAT. Accordingly, the transferor is not entitled to recover input VAT incurred on related expenses.

The seller may however opt to VAT to the extent that the option conditions are met. As a consequence, input VAT incurred on related costs is recoverable.

The leasing or letting of immovable property is also exempt from VAT (with some exceptions) unless the conditions to opt for VAT are met. VAT incurred on costs linked to a VAT exempt leasing or letting of immovable property is not recoverable. In case of mixed use, ie, partially VAT taxable use and partially VAT exempt use, an allocation key needs to be determined to recover input VAT on costs.

For a detailed explanation, see section "*Indirect taxes/Value-added tax (VAT)*" above.

Registration duties

The transfer (either by way of sale or capital contribution) of immovable property located in Luxembourg is subject to registration duties.

The registration duty is 6%, plus a 1% transcription tax. A municipal surcharge of 50% on the value of the registration duties is also due where the property is located within the Luxembourg City municipality (ie, combined rate of 10%).

These duties are normally computed on the higher of the sales price or the market value. If the sale is subject to VAT, the taxable amount includes the VAT.

The Luxembourg law provides for a reduced rate where immovable property is contributed to a company in exchange for shares. In such case, the registration of the deed is subject to proportional registration duties at the rate of 0.6% and the related transcription duty of 0.5% (ie, combined rate of 1.1%) plus a municipal surcharge of 0.3% where the immovable property is located in the municipality of Luxembourg City (ie, combined rate of 1.4%).

A contribution of immovable property, remunerated by other means than issue of shares, is subject to the same registration duties as for a sale (ie, 6%, plus transcription tax of 1% plus municipal surcharge of 3% in Luxembourg City).

A fixed registration duty (relatively low – 75 EUR plus the related stamp duty and other duties applied by the administration) applies in case a contribution of immovable property to a company is performed in the framework of a "restructuring transaction". A "restructuring transaction" is defined as being the contribution, by one or several companies, of all their assets and liabilities or one or several lines of business, to one or several companies, as long as such contribution is mainly made in exchange for shares issued by the acquiring company(ies) and representing its/their capital.

Investment in a property company

Legal framework

Although the Companies Act provides for several types of companies, in practice it seems that the types of companies most commonly adopted are the private limited liability company (ie, *société à responsabilité limitée*, or S.à r.l.) and the public limited liability company (ie, *société anonyme*, or S.A.). One of the main features of these forms of companies is that the shareholders are liable only up to the nominal value of the shares they own.

The minimum capital is 12,000 EUR (or equivalent in other currency) for an S.à r.l. and 30,000 EUR (or equivalent in other currency) for an S.A.

It has to be noted that a statutory auditor must be appointed by the shareholders of an S.A. to check the financial statements of the company (no statutory auditor is required for an S.à r.l.). An external auditor will be required for an S.A. and an S.à r.l. only if the company exceeds certain criteria set out in the law. In the event of a contribution in kind, an external valuation report is required for an S.A. (not required in case of S.à r.l. where a valuation statement prepared by the founders or the board of managers, as the case may be, is sufficient).

Tax aspects

Investment in a property company by individuals

Resident individuals

Dividends
Dividends paid by a resident company are subject to WHT at 15%.

Dividend income forms part of the worldwide income of a resident taxpayer subject to progressive income tax rates. An exemption of 1,500 EUR (doubled for taxpayers taxable jointly) applies on total investment income (interest, dividends, income from portfolio investments, etc) received during the tax year.

Finally, if dividends are paid by a Luxembourg resident company that is fully liable to CIT, or an EU company listed in the EU Parent-Subsidiary Directive, or a capital company fully liable to a tax corresponding to Luxembourg CIT and that is resident in a country with which Luxembourg has signed a tax treaty, 50% of the dividend income is exempt from Luxembourg taxation.

Capital gains
Capital gains arising from the disposal of shares occurring less than six months subsequent to the acquisition date are taxable as miscellaneous income, and consequently added to the other income of the taxpayer for determining the taxable basis. The amount is taxed at normal personal income tax rates.

Capital gains subject to tax also include gains arising from the disposal of a substantial shareholding (ie, more than 10% of the shares held alone or together with spouse and minor children, directly or indirectly, at any time during the five years prior to the day of disposal) in a limited liability or co-operative company to the extent that the disposal takes place more than six months after the date of acquisition. In such a case, the taxpayer may benefit from a lump-sum deduction of 50,000 EUR for a single person or 100,000 EUR for married couple/partners taxable jointly. The personal income tax rate is 50% of the marginal tax rate (maximum 21% for 2020).

Non-resident individuals

Dividends
Dividends paid by a Luxembourg resident company to a non-resident individual shareholder are subject to WHT of 15%, with the possibility of reduced rates under DTTs.

For non-residents, this WHT is a final tax charge in Luxembourg. However, this WHT can potentially be credited against the income tax liability of the home country under a DTT.

Capital gains
Non-resident taxpayers are only taxable on capital gains realised on the sale of shares in the following situations:

- disposal of a major shareholding (ie, more than 10% of the shares held alone or together with spouse and minor children, directly or indirectly, at any time during the five years prior to the day of disposal) in a company having its registered office or principal establishment in Luxembourg, within six months of the acquisition of the shareholding. In this case, the capital gain will be subject to tax on income at the normal rates (ie, according to progressive income tax rates with a maximum to 42% for 2020);
- disposal of a major shareholding in a Luxembourg company by a person who has been resident in Luxembourg for more than 15 years and has subsequently become a non-resident less than five years before the realisation of the capital gains on the shares. In this case, the purchase price can be re-valued to account for inflation. Moreover, the personal income tax rate corresponds to 50% of the marginal tax rate (maximum 21% for 2020).

DTTs concluded between the state of residence and Luxembourg may provide for an exemption from capital gains taxation.

Investment in a property through a Luxembourg *société civile immobilière*

Legal aspects

The *société civile immobilière* (SCI) form is governed by the Luxembourg Civil Code. It constitutes a pooling of professional property in a legal structure distinct from an operating business. It may be referred to as a *société civile immobilière de gestion* when its objective is to manage property that it owns and that it leases to an operator. The net income that may be generated under such leasing is distributed between the partners.

In such kind of structure, the act of will of the partners is fundamental. As a consequence, each partner's liability is unlimited, and the liability is proportional to the number of partners and does not depend on the share capital held by each of them.

The SCI may be established by at least two or more partners, either under a notarial deed or under private contract to be published in the Luxembourg Trade and Companies Register. There is no minimal capital requirement for an SCI.

Tax aspects

From a Luxembourg tax perspective, the SCI is considered a transparent vehicle and thus is taxed only at the level of its partners. Depending on the partners the taxation will follow the rules of personal tax or of corporate taxes.

Personal income tax
Any individual (resident or non-resident) partner of an SCI will be taxed on income arising in the SCI (rental income and capital gains realised on the sale by the SCI of the property), as if this income had been directly realised by him, in accordance with the rules described in the section "*Direct investment in Luxembourg property by individuals*".

Corporate income tax
Any company (resident or non-resident) partner of an SCI will be taxed on income arising in the SCI, as if the company had directly realised this income, in accordance with the rules described in the section "*Direct investment in Luxembourg property by a holding company*".

Municipal business tax
SCIs are liable to municipal business tax if they carry out a commercial activity in Luxembourg.

Capital gains
Profits resulting from the disposal of the SCI's shares will be considered as a sale of the building itself and will follow the taxation principles applicable to its partners.

Registration duty
Real estate transactions performed by an SCI are subject to the same rules as outlined in the section "*Direct investment in real estate*". However, a transfer of shares in an SCI is assimilated to a direct transfer of the real estate property held by the SCI from a registration duty perspective.

VAT
A Luxembourg company merely holding shares in an SCI should not be considered as a VATable person unless it carries out other economic activities (eg, granting of interest bearing loans).

The transfer of shares in an SCI is usually VAT-exempt.

Investment in a property company by a holding company

Resident company

Dividend income
Dividends received by a Luxembourg resident company are in principle subject to CIT and municipal business tax at the aggregate rate of 24.94% for 2020 (for Luxembourg City).

However, these dividends received may be exempt from CIT and municipal business tax provided the following conditions to benefit from the Luxembourg participation exemption regime are satisfied:

- The distributing company is:
  - a fully taxable Luxembourg joint-stock company;
  - a non-resident joint-stock company that is fully liable in its state of residence to a tax corresponding to the Luxembourg CIT. Regarding this condition, the Luxembourg tax authorities have set the rule that the foreign tax must be assessed at a minimum rate of 8.5% on a taxable basis determined similarly to that in Luxembourg; or
  - a company that is resident in an EU Member State and covered by Article 2 of the EU Parent-Subsidiary Directive.
- The beneficiary company is:
  - a fully taxable Luxembourg joint-stock company;
  - a Luxembourg PE of a company that is resident in an EU Member State and falling under Article 2 of the EU Parent-Subsidiary Directive; or
  - a Luxembourg PE of a joint-stock company that is resident in a state with which Luxembourg has concluded a DTT.
- At the date on which the income is made available, the beneficiary has held or undertakes to hold, directly, for an uninterrupted period of at least 12 months, a participation in the share capital of the subsidiary of at least

10% or with an acquisition price of at least 1.2 million EUR. If the participation is held through a Luxembourg tax transparent entity, this will be regarded as direct participation proportionally to the interest held by the Luxembourg holding company in the tax transparent entity.

However, according to the general principle in LITL which denies the deductibility of expenses connected to exempt income, any charges incurred during the year in which the dividend is received, and which are connected to the exempt participation are not deductible. Additionally, if a write-down in the value of the participation has been booked either as a consequence of the distribution of dividends or otherwise, this write-down will not be deductible up to the amount of the exempt dividend.

The European general anti-avoidance provision, amending the participation exemption regime under the EU Parent-Subsidiary Directive, has effectively been incorporated into Luxembourg law. The provision precludes the Directive benefits, in situations where there are arrangements which have been put into place for the main purpose or one of main purposes of obtaining a tax advantage that defeats the object or purpose of the Directive and are not genuine, having regard to all relevant facts and circumstances. This entails that for the purpose of this rule, an arrangement must be regarded as not genuine insofar as it has not been put into place for valid commercial reasons which reflect economic reality.

Dividend payments made by a corporate entity in another EU Member State that previously qualified for the participation exemption need to be analysed under the new provision. Where the corporate entity paying the dividend is fully liable to a tax corresponding to the Luxembourg CIT, the participation exemption remains available; since such situations are not subject to the anti-avoidance constraint.

The exemption from CIT for dividend received is also not applicable if the income flow gives rise to a corresponding tax-deductible expense at its source, where the source is a corporate entity in another EU Member State.

Capital gains
Capital gains resulting from the sale of a shareholding are in principle subject to CIT and municipal business tax at the aggregate rate of 24.94% for 2020 (for Luxembourg City).

However, such capital gains can often be exempt from CIT and municipal business tax, provided that the following conditions for benefitting from the participation exemption regime are satisfied:

- The participation is in:
  - a fully taxable Luxembourg joint-stock company; or
  - a non-resident joint-stock company that is fully liable to a tax corresponding to the Luxembourg corporate tax. Regarding this condition, the Luxembourg tax authorities have set the rule that the foreign tax must be assessed at a minimum rate of 8.5% on a taxable basis determined similarly to that in the Luxembourg, or a company that is resident in an EU Member State and falling under Article 2 of the EU Parent-Subsidiary Directive.
- The beneficiary is:
  - a fully taxable Luxembourg joint-stock company;
  - a local PE of a company that is resident in an EU Member State and falling under Article 2 of the EU Parent-Subsidiary Directive; or
  - a local PE of a joint-stock company that is resident in a state with which Luxembourg has concluded a DTT.
- At the date on which the alienation takes place, the beneficiary has held or undertakes to hold the respective participation for an uninterrupted period of at least 12 months, and during this period the participation held does not fall below 10% or an acquisition price of less than 6 million EUR. If the shares are held through a Luxembourg tax transparent entity, this requirement must be fulfilled not by the tax transparent entity itself, but by the beneficiary, proportional to the interest held by the latter in the tax transparent entity.

A recapture system exists, under which the exempt amount of the gain is reduced by the algebraic sum of any expenses principally connected with the participation (such as financing costs and write-downs in the value of the participation), to the extent that they have reduced the taxable base of that year or previous years. Basically, an effect of this rule is that the capital gain realised will become taxable up to the amount of the aggregate expenses and write-downs deducted during the respective and previous years in relation to the participation.

Financing arrangements
Financing arrangements entered into by Luxembourg holding companies that invest into property companies are frequently structured so that debt type financing is predominant. The main driver for this is often a need to maximise the flow of profits being repatriating to investors which takes the form of interest, and hence which does not attract WHT, irrespective of the territory of residence and other tax attributes of the investors. Tax characterisation as debt is usually readily possible for a broad range of financing instruments.

In situations where a Luxembourg resident company is used to borrow and then provide finance in the form of loans to property companies, as well as to hold shares in such companies, it may need to fulfil the requirements laid down by the Luxembourg transfer pricing Circulars.

ATAD

On 18 December 2018, the Luxembourg Parliament voted for bill (No 7318) (the "ATAD I Law"), implementing ATAD I in Luxembourg domestic law. The Law was published on 21 December 2018 and entered into force on 1 January 2019 with respect to the following measures:

- interest deduction limitation rules (BEPS Action 4) – Article 4 of ATAD I;
- controlled foreign company rules (CFC) (BEPS Action 3) – Articles 7 and 8 of ATAD I;
- intra-EU anti-hybrid rule (BEPS Action 2) – Article 9 of ATAD I was replaced by ATAD II rules (see below); and
- general anti-abuse rule (GAAR) – Article 6 of ATAD I.

The exit tax rules (Article 5 of ATAD I) came into force on 1 January 2020.

The ATAD I Law also includes two additional amendments to the domestic law, both not directly linked to the ATAD I text. These measures concern tax neutral exchanges, and the domestic definition of a PE.

Interest deduction limitation rules (Article 4 of the ATAD I) might particularly affect real estate structures.

Interest deduction limitation rules

Among other measures, ATAD I Law includes an interest deduction limitation rule (Article 4 of the ATAD), which adheres to the rules that have been recommended by the OECD in the context of BEPS Action 4 ("*Limiting Base Erosion Involving Interest Deductions and Other Financial Payments*"). The interest deduction limitation rule restricts, in principle, deduction of "exceeding borrowing costs" to 30% of the taxpayer's EBITDA (Article 4(1)).

The definition of "borrowing costs" includes interest expenses on all forms of debt, other costs economically equivalent to interest and expenses incurred in connection with the raising of finance as defined in national law, including payments under profit participating loans and the finance cost element of finance lease payments.

"Exceeding borrowing costs" is defined as the amount by which the deductible borrowing costs of a taxpayer exceed its taxable interest revenues and other economically equivalent taxable revenues according to national law. Where a taxpayer is included for tax purposes in a group (eg, under a tax consolidation or group relief regime), the EU Member State may apply the interest deduction limitation rule on the overall position of all entities included in the group.

The ATAD I Law introduced a new Article 168bis into the text of the LITL.

As exceptions to the interest deduction limitation rules, the following is allowed:

- full deduction if excess borrowing of the taxpayer's (group) does not exceed 3 million EUR per year;
- full deduction if the taxpayer is a standalone entity; and
- the exclusion of loans for EU long-term infrastructure projects.

For real estate structures with a platform in Luxembourg, the interest deduction limitation rules should have an impact on non-qualifying income, as deductible interest offsetting taxable income would be limited.

For real estate structures with a Luxembourg property company, interest deduction limitation rule should not trigger additional tax leakage in Luxembourg if the property is located abroad. The proceeds derived from the real estate asset being usually exempt in Luxembourg based on a DTT, interest charges related to the financing of the building should not be tax-deductible in Luxembourg.

Should the property be located in Luxembourg, interest deduction limitation rule might trigger additional tax leakage.

ATAD II

On 19 December 2019, the Luxembourg Parliament voted to approve the law implementing the EU Anti-Tax Avoidance Directive as regards hybrid mismatches with third countries (ATAD II) into Luxembourg domestic law (the "ATAD II Law"). The Law generally follows the text of ATAD II rather closely, adapting it mainly to integrate with the structure and terminology used in the LITL. The ATAD II Law applies to tax years starting as from 1 January 2020, with the additional "reverse hybrid" measures that comprise Article 9a of ATAD II applying from the 2022 tax year, ie, to tax years closing in 2022. For taxpayer having a tax year diverging from the calendar year, this means that Article 9a of ATAD II may apply to them already in 2021.

The ATAD II Law aims at preventing "deductions without inclusion" and "double deductions" caused by "hybrid mismatch" tax treatments. A "hybrid mismatch" may be defined as the difference in the legal characterisation of a financial instrument (eg, debt in the jurisdiction of a payer and equity in payee's jurisdiction) or an entity (ie, tax transparent in one jurisdiction but opaque from another jurisdictions' perspective).

Hybrid mismatch outcome may arise if it involves associated enterprises. An associated enterprise means an entity or an individual, which holds directly or indirectly, a participation of more than 25% (50% in case of a hybrid entity) of voting rights, capital ownership or profits of another entity (by taking into consideration also the "acting together" concept).

It should be considered to identify and to monitor the investor base to avoid the deductibility concerns at the level of the Luxembourg entities (or any additional layer of taxation at the fund level).

DAC 6

DAC 6 provides for a mandatory disclosure of certain cross-border arrangements by intermediaries or relevant taxpayers to the tax authorities and mandates automatic exchange of this information among EU Member States (taking place every quarter). As a result, tax intermediaries who provide their clients with complex cross-border financial schemes may be obliged to report these structures to their tax authorities. Similar reporting obligations may apply to fund promoters.

On 21 March 2020, the Luxembourg Parliament voted to approve the bill (No 7465) implementing the EU Directive into local law. This DAC 6 Law is applicable since 1 July 2020. The first reportable transactions will however be those whose first implementation step occurred between 25 June 2018 and 1 July 2020 (transitory period). According to the DAC 6 Law, the relevant information would then have to be reported to the Luxembourg tax authorities by intermediaries (or relevant taxpayers) by 31 August 2020.

However, on 22 July 2020, the Luxembourg Parliament voted to approve the draft bill (No 7625), which was published in the Memorial on 24 July 2020 to enact the extension of reporting deadlines, in accordance with the provisions of the Directive 2020/876 adopted on 24 June 2020. According to the Law of 24 July 2020, the final deadline for filing arrangements linked to the transition period is postponed to 28 February 2021. In addition, the date for the beginning of the period of 30 days for reporting by intermediaries (or relevant taxpayers) on reportable cross-border arrangements for which the first step of implementation occurs between 1 July 2020 and 31 December 2020 (the "post-transition" period) is changed from 1 July 2020 to 1 January 2021.

Investment structures should be analysed by intermediaries or relevant taxpayers to identify potential reportable cross-border arrangements and to assess any reporting obligations towards the Luxembourg or foreign tax authorities based on the applicable local law. And even if, based on the local assessment, no reporting is required, a proper documentation would be crucial and might serve as a proof for DAC 6 compliance.

MLI

The BEPS package includes a number of recommendations that would have to be implemented through bilateral tax treaty amendments. The MLI covers most of the tax treaty measures developed in the course of the OECD BEPS project under

- BEPS Action 2 ("*Neutralising the Effects of Hybrid Mismatch Arrangements*");
- BEPS Action 6 ("*Preventing the Granting of Treaty Benefits in Inappropriate Circumstances*");
- BEPS Action 7 ("*Preventing the Artificial Avoidance of PE Status*"); and
- BEPS Action 14 ("*Making Dispute Resolution Mechanisms More Effective*").

The MLI does not override, nor substitute for, existing bilateral or multilateral tax conventions that signatories have in place but, rather, supplements those conventions with a series of BEPS-related provisions, many of which would override specific provisions in current bilateral agreements.

On 3 July 2018, the Luxembourg Government also introduced a bill of Law approving the text of the Multilateral Instrument (MLI). On 14 February 2019, the Luxembourg's *Chambre des Députés* voted to approve the Law, necessary to ratify the text of the MLI. On 9 April 2019, Luxembourg deposited the formal instrument of ratification with the OECD.

The MLI formally entered into force for Luxembourg on 1 August 2019.

The dates on which the provisions of the MLI that apply to Luxembourg's DTT network then actually come into effect are variable, as these depend on the timing of ratification of the MLI by each relevant treaty co-signatory. However, it is now clear that, insofar as the "principal purposes test" in the MLI potentially limits the treaty benefits of reduced or zero rates of WHT, for many of Luxembourg's treaties these MLI measures took effect on 1 January 2020.

VAT

A Luxembourg company merely holding shares in a property company should not be considered as a VATable person unless it carries out an economic activity beyond its passive holding activity.

The transfer of shares is usually VAT-exempt.

Non-resident company

Dividend income
Dividends paid by a Luxembourg company to a non-resident company that are not attributable to its Luxembourg PE are subject to WHT of 15%, but with the possibility to benefit from reduced rates or exemption, through application of either the Luxembourg participation exemption regime or DTTs.

Capital gains
Luxembourg taxation of capital gains resulting from the sale of shares by a non-resident company is relatively limited in scope.

The capital gain is only taxable in the following situations:

- disposal of a major shareholding (ie, more than 10%) held in a company having its registered office or its principal establishment in Luxembourg, within six months of the acquisition of the shareholding; and
- disposal of a major shareholding in a Luxembourg company by a company who has been resident in Luxembourg for more than 15 years within five years of the company becoming non-resident.

In the first situation, the taxation will be levied on the net capital gain received. If, however, the gain is taxable because the company had previously been resident in Luxembourg for more than 15 years, the company will be able to re-value the purchase price to account for inflation.

In practice, this taxation does not frequently happen as most of the DTT signed by Luxembourg will prevent from that taxation.

Investment in a foreign property by a Luxembourg company

Luxembourg companies are also frequently used to invest directly into real estate located abroad (eg, in the United Kingdom or in Germany).

Luxembourg companies are in principle subject to CIT and municipal business tax on their worldwide income at the aggregate rate of 24.94% for 2020 (for Luxembourg City). However, generally, DTTs to which Luxembourg is party give the right to tax income (that is rents plus capital gains on disposal) derived from real estate property to the state in which the property is located (in line with Article 6 of the OECD Model Convention). In such a situation, the income received by the Luxembourg company from real estate located abroad is generally “exempt with progression” from Luxembourg taxation in accordance with the clause within the treaty dealing with the elimination of double taxation or under the Luxembourg domestic legislation. However, provided that charges in economic relation to this exempt income, such as financing costs, are not deductible from the CIT and municipal business tax bases. The overall effect is usually to leave a tax base in Luxembourg arising solely from income and expenses not directly connected to the real estate. For example, interest income for surplus rental income would be taxable.

If a Luxembourg company is financed with debt denominated in foreign currency, any foreign exchange differences arising on such financing would normally be subject to Luxembourg taxation, since a Luxembourg company must in principle file its Luxembourg annual tax return in euro. (It should be noted that the foreign exchange differences booked will generally not be regarded as exempt under the real estate article of the applicable DTT).

To avoid taxable “forex” exposure, a “functional currency” treatment may be applied, to allow a Luxembourg company to file its tax returns in the relevant foreign currency and to convert its taxable result into euro using the year-end exchange rate, so that any foreign exchange result in Luxembourg may be mitigated. The request needs to be filed within certain deadlines.

Real estate located in a country with which Luxembourg has a DTT is generally exempt from net wealth tax in Luxembourg. Conversely, any debt financing this real estate is considered non-tax deductible from the net wealth tax basis.

The most common exit scenario for this type of structure is the disposal of the shares in the Luxembourg company owning the foreign real estate. While the transfer of Luxembourg properties is usually subject to transfer taxes ranging from 7% to 10% (computed on the higher of the sales price and the market value), the transfer of shares in a company holding Luxembourg properties is generally not subject to any Luxembourg transfer taxes.

The Luxembourg company owning the real estate in another country would qualify as a VAT taxable person in Luxembourg although the property is located abroad. This may trigger a VAT registration and compliance obligations for the company in Luxembourg and in the country where the real estate is located.

Substance considerations

One growing issue in international taxation is the requirement by foreign tax administrations for genuine substance for real estate vehicles (and more generally in international tax structures as well) in order to benefit from desired tax attributes (ie, tax treaty eligibility, application of EU Parent-Subsidiary Directive, avoidance of CFC rules, etc). A lack of substance may thus lead a foreign tax administration to conclude that a specific entity is purely artificial and should be disregarded from a fiscal point of view.

Luxembourg entities may hence need to be provided with sufficient "business substance" in terms of purpose of the business, and sufficient "material substance" (ie, office premises, equipment, staff, etc).

The requirements for substance for these entities are determined primarily by the tax rules of the country where the property owning entity is incorporated or where the asset is located. These requirements vary from country to country and should, therefore, be considered on a case-by-case basis.

It is important to point out that these requirements impact not only Luxembourg, but all locations playing a role in the real estate sector (and in the international tax structuring arena). In this respect, it should be stressed that Luxembourg services providers have been accustomed to assisting in the provision of such a level of substance for many years now. Notably, the pool of suitably qualified resources available in Luxembourg and in neighbouring countries within commuting distance to Luxembourg make it easier for Luxembourg than for some other jurisdictions to satisfy the substance requirement for, especially, staffing.

According to LITL, a company is considered to be resident in Luxembourg, and therefore fully taxable therein, if either its registered office or central administration is located in Luxembourg.

To avoid the risk of challenge by other tax authorities, it is usually recommended that it can be evidenced that a Luxembourg company is effectively managed and controlled in Luxembourg and that minimum substance exists in Luxembourg (eg, bookkeeping, phone line, etc).

Transfer pricing requirements related to the substance have been reinforced and highlight the need to have a majority of the board of directors tax resident in Luxembourg and that the personnel is sufficiently qualified to control the transactions performed.

Real estate investment vehicles

Luxembourg offers a wide range of regulated and non-regulated fund vehicles that can usually meet the different requirements of real estate fund promoters and managers readily.

Choosing one real estate fund vehicle over another will mainly depend on the type of funding that needs to be raised, the type of investors targeted, the flexibility sought in terms of running the fund, and specific investor tax considerations. In particular, the Luxembourg tax regime is a key factor when considering the choice of an unregulated or a regulated real estate investment vehicle for international investors.

The tax regime applicable to unregulated holding companies owing real estate owning subsidiaries has already been described in the section "*Investment in a property company by a holding company*". It is, however, noted that this type of holding and financing company is extremely popular with fund managers and promoters globally, who are seeking a tax regime that has attributes that favour a "platform" for managing investments into a geographic region rather than a single territory for investment. Luxembourg is for this reason, the holding and financing location of choice, in particular for pan-European and Asian real estate funds, even when the fund vehicle itself is not set up in Luxembourg.

The Directive 2011/61/EU of 8 June 2011 (AIFMD) and the Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012 supplementing the AIFMD, as transposed in the Luxembourg Law of 12 July 2013 (the "2013 Law"), should be considered in the setup of a Luxembourg real estate investment fund vehicles. In fact, the AIFMD wide scope captures almost all collective investment vehicles that are not UCITS-compliant and also regulates the alternative investment fund managers (AIFMs), whether they manage alternative investment funds (AIFs) established inside or outside the EU, but also non-EU AIFMs that market AIFs in the EU.

The main purposes of the AIFMD are providing greater investors protection, mitigating systemic risks and providing for a global European regulation framework and market for alternative funds similar to the one implemented for UCITS. The AIFMD regulates AIFMs and not the products themselves. The AIFMD, however, defines AIFMs as any legal person whose regular business is managing one or more AIF that are in scope of the AIFMD.

The Luxembourg VAT law provides for a VAT exemption applicable to the management of regulated funds and vehicles that qualify as alternative investment funds (AIF).

Regulated real estate investment fund vehicles

Most regulated real estate investment fund vehicles established in Luxembourg are undertakings for collective investment (UCIs), falling within the scope of either the Luxembourg Law on Undertakings for Collective Investment (UCI) of 17 December 2010 (the "2010 Law"), as amended, or the Law relating to specialised investment funds (SIF) of 13 February 2007, as amended (the "SIF Law"), or the Law introducing the reserved alternative investment fund (RAIF) dated 23 July 2016 (the "RAIF Law").

In addition, the Law of 15 June 2004, as amended, created the investment company in risk capital (*société d'investissement en capital à risque*, or SICAR) as a dedicated vehicle for qualified investors investing in venture capital and private equity. Under certain conditions, the SICAR can also be used as a vehicle for real estate investments. In particular, RAIF might adopt SIF or SICAR regime. For further details on SIF and SICAR regimes, see below.

Real estate investment funds

Regulatory aspects

Luxembourg regulated investment funds in general and real estate investment funds in particular have the following general legal features.

Corporate versus contractual legal form

Luxembourg investment funds can be set up in either the corporate form or the contractual form. The key factor in selecting one or the other form is often the tax treatment applicable to investors.

The two corporate forms of investment funds are:

- the *société d'investissement à capital variable* (SICAV), which is an investment company with a variable share capital that at all times equals the net asset value (NAV) of the fund. The share capital of the SICAV is automatically increased or reduced upon issue or redemption of shares. The SICAV is the most commonly chosen form.
- the *société d'investissement à capital fixe* (SICAF), which is an investment company with fixed capital. Fixed capital in this context means that the par or nominal value of the issued capital does not change, and the share capital may only vary in accordance with legal requirements.

The *fonds commun de placement* (FCP) is an unincorporated co-propriety of assets, broadly equivalent to a unit trust in the United Kingdom. Having no separate legal status, the FCP must be managed by a management company. The FCP is, however, not liable for the obligations of the management company. Luxembourg FCPs are frequently used as fund vehicles for real estate funds and are well known by the wider European market.

Following the implementation of the AIFMD in Luxembourg, the limited partnership legislation has been modernised. In particular, a new "special partnership" (*société en commandite spéciale*, or SCSp) without legal personality was introduced, as well as the legal framework of the existing Luxembourg limited partnership (*société en commandite simple*, or SCS), which has legal personality, has been modernised. Both the investment company in risk capital (SICAR) and specialised investment funds (SIF) may adopt the form of an SCS/SCSp.

Open-ended versus closed-ended investment funds

FCPs, SICAFs and SICAVs may operate as open-ended or closed-ended funds.

Open-ended investment funds have rules that allow investors to request that the fund repurchases their units each time redemptions are possible according to the prospectus.

By contrast, closed-ended investment funds may not, at the request of investors, repurchase their shares or units; the fund governing bodies decide when redemptions are possible.

Sub-funds and classes of shares

Investment funds can have various sub-funds (the terminology used is that of "umbrella fund"), each with a different investment policy or restricted to certain investors. The principle of segregation applies, meaning that each sub-fund is treated as a separate entity where the assets of one sub-fund cannot be used to settle the liabilities of another sub-fund.

Investment funds can further issue several classes of shares (however with no segregation between the classes of shares) with different fee levels, different minimum subscription amounts, different investor profiles (institutional/retail), different income policy (distributing or capitalising shares), different currencies, etc.

Regulatory aspects for the UCIs

The main features of Part II UCIs (being UCIs subject to Part II of the 2010 Law) are summarised as follows:

Common rules applicable to all Part II UCIs	
Legal forms available	• investment company with variable capital (SICAV); • investment company with fixed capital (SICAF); • contractual fund (FCP).
Eligible investors	no restriction on the type of investors authorised to invest in a Part II UCI
Licensing requirements	Part II UCIs must receive the prior authorisation of the *Commission de Surveillance du Secteur Financier* (CSSF) before it can start its activities. The CSSF will pay particular attention to: • the fund's draft constitutional and offering documents, notably the prospectus and the articles of incorporation/management regulations; • the identity of the promoter of the fund, which must be a professional in the financial sector and must have sufficient financial surface; • the identity of the investment manager of the fund which must be duly licensed for that function in its country of domicile; • the identity of the persons in charge of conducting the business of the fund; they must show good reputation and adequate experience for acting in such capacity; • the identity of the Luxembourg central administration, the Luxembourg depositary and the Luxembourg external auditors; • the identity of the AIFM or the Chapter 16 management company.
Compulsory service providers in Luxembourg	• depositary: responsible for safekeeping of the UCI assets and certain other supervisory duties – must be a Luxemburg bank or Luxembourg branch of a foreign bank; • central administrator: responsible for accounting, NAV calculation, keeping of the register of the shareholders/unit holders, handling subscriptions and redemptions, communication with investors and preparation of financial statements – which must be a Luxembourg bank or a branch of a foreign bank or a professional of the financial sector with a proper license; • external auditors; • AIFM or Chapter 16 management company: unless the Part II UCI benefit from the exemptions provided by the AIFMD. The AIFM/Chapter 16 management company can be established either in Luxembourg, in another EU Member State or in a third country.
Subscription/Redemption	subscription at NAV plus subscription fees; can also be closed to subscriptions; redemption price must in practice be made at NAV minus redemption fees; can also be closed to redemptions
Minimum capital requirement	The net assets of an FCP may not be less than 1,250,000 EUR, to be reached within six months following its authorisation. The minimum capital of a self-managed SICAV/SICAF may not be less than 300,000 EUR at the date of authorisation. The capital of any SICAV/SICAF must reach 1,250,000 EUR within a period of six months following its authorisation.
Documents to be established according to laws and regulations	• prospectus; • articles of association (in case of a SICAV/SICAF); • management regulations (in case of an FCP); • agreements with the service providers; • annual audited financial statements (annually within four months of period end); • semi-annual non-audited financial statements (annually within two months of period end); • long form report describing the organisation of the fund (annually within four months of period end).
Valuation principles	Valuation is made based on the realisable value of the real estate assets, estimated in good faith (unless differently provided for in the constitutional documents of the fund).

In addition, the CSSF has set up separate rules for investment in real estate, as set out in Chapter I of the CSSF Circular 91/75 of 21 January 1991, as amended and supplemented by the CSSF Circular 05/177. As these specific rules come from the CSSF Circular rather than the law itself, they may, in certain cases, be derogated subject to proper justification vis-à-vis the CSSF.

The main specific rules applicable to Part II real estate funds can be summarised as follows:

Specific requirements applicable to Part II real estate funds only	
Definition of eligible real estate assets	land and/or buildings registered in the name of the UCI; shareholdings in real estate companies (including debt securities of such companies), ie, companies whose exclusive object and purpose is the acquisition, promotion and sale, as well as the letting and agricultural lease of property, provided that these shareholdings must be at least as liquid as the property rights held directly by the UCI; property-related long-term interests, eg, surface ownership, lease-holds, and option rights on real estate
Maximum investment in one property	maximum 20% of fund/sub-fund's net assets in a single property; property whose economic viability is linked to another property is not considered a separate item of property; This restriction (i) is not applicable during the start-up phase of the fund, which may not extend beyond a four-year period following the closing date of the initial offer period and (ii) is to be considered at the date of acquisition of the real estate property.
Maximum leverage	borrowings may not exceed 50% of the valuation of all properties in the fund
Minimum liquid assets in the fund	no minimum foreseen by regulation but the fund's liquidity features must be in line with sections dealing with investors' ability to redeem as per the prospectus
Minimum frequency of NAV calculation	once a year and each time shares or units are issued to, or redeemed from, investors; management may use the valuation established at the year-end throughout the following year unless there is a change in the general economic situation or in the condition of the properties which requires new valuations to be carried out under the same methods as those used for the annual valuation
Requirement for independent valuation of the properties	at least annually and each time properties are bought or sold; valuation to be performed by recognised professionals in the Real Estate sector
Borrowings	may not exceed on average 50% of the assets

Regulatory aspects for SIFs and RAIFs	
Legal forms available	• investment company with variable capital (SICAV) to be incorporated as a public limited company (S.A.), a private limited company (S.à r.l.), a cooperative company organised as a public limited company (SCoopSA), as a corporate partnership limited by shares (S.C.A.), as limited partnership (SCS) or as special limited partnership (SCSp); • investment company with fixed capital (SICAF); • contractual fund (FCP)
Eligible investors	well-informed investors only, ie, institutional investors, professional investors and other investors provided that they formally declare themselves as well-informed investors and either invest a minimum of 125,000 EUR or obtain a certificate from a regulated entity confirming their understanding of the risks associated to the investment in a SIF/RAIF; The SIF/RAIF must put in place arrangements to ensure compliance with this requirement.
Licensing requirements	A SIF must receive prior authorisation of the CSSF before it can start its activities. The CSSF will pay particular attention to: • the fund's draft constitutional and offering documents; • the identity of the investment manager of the fund which must be duly licensed for that function in its country of domicile;

	• the identity of the persons in charge of conducting the business of the fund; they must show good reputation and adequate experience for acting in such capacity; • the identity of the Luxembourg central administration, the Luxembourg depositary and the Luxembourg external auditors. SIFs are required to inform the CSSF and comply with specific requirements in case of delegation of functions. Moreover, SIFs must implement an appropriate system of risk management and must be structured and organised in a manner to reduce to a minimum the conflicts of interest. A RAIF will not be subject to any authorisation or direct supervision from the CSSF. The RAIF shall also benefit from an exemption from CSSF's authorisation for its set-up and for the supervision regarding ongoing amendments to offering documents during the life of the fund, being the fund only indirectly supervised through its AIFM.
Compulsory service providers in Luxembourg	• depositary: responsible for safekeeping the SIF/RAIF assets – must be a Luxemburg bank or Luxembourg branch of a foreign bank; • central administrator: responsible for accounting, NAV calculation, keeping of the register of the shareholders/unit holders, handling subscriptions and redemptions, communication with investors and preparation of financial statements – which must be a Luxembourg bank or a branch of a foreign bank or a professional of the financial sector with a proper license; • a Chapter 16 management company or an AIFM if the fund is set up as an FCP; a RAIF must appoint an authorised AIFM regardless of its legal form; • external auditors
Subscription/ Redemption	Subscription price can be freely determined in the offering document; it can also be closed to subscriptions. Redemption price can be freely determined in the offering document; it can also be closed to redemptions.
Minimum capital requirement	The net assets of a SIF/RAIF may not be less than 1,250,000 EUR, to be reached within a period of 12 months following its authorisation. Only 5% of the capital needs to be paid up on subscription.
Documents to be established according to laws and regulations	• offering document; • articles of association (in case of a SICAV/ SICAF); • management regulations (in case of an FCP); • agreements with the service providers; • annual audited financial statements (annually within six months of period end)
Valuation principles	fair value unless derogated in the fund constitutional and offering documents
Maximum investment in one property	maximum 30% of fund/sub-fund's gross assets in a single property
Maximum leverage	no maximum foreseen by regulation, but the CSSF checks that the maximum leverage indicated in the prospectus is acceptable
Minimum liquid assets in the fund	no minimum foreseen by regulation but the fund's liquidity features must be in line with sections dealing with investors' ability to redeem as per the prospectus
Minimum frequency of NAV calculation	once a year
Requirement for independent valuation of the properties	at least annually and each time properties are bought or sold; valuation to be performed by recognised professionals in the real estate sector

Particular tax implications

Taxation of the fund entity

Luxembourg real estate funds (UCIs and SIFs), whether they invest directly into real estate properties or into securities (shares and loans in/to real estate property companies) are not subject to CIT, municipal business tax and NWT in Luxembourg.

However, fund entities are subject to an annual subscription (*droit d'abonnement*) tax of five basis points (ie, 0.05%), which is payable and calculated quarterly, based on the fund's NAV at the end of each quarter. A reduced rate of one basis point annually (ie, 0.01%) is applicable to real estate funds subject to the SIF Law, as well as to compartments and share classes of real estate funds subject to 2010 Law that are dedicated to institutional investors. Holdings in other Luxembourg funds, which have already been subject to subscription tax, are excluded from the subscription tax in any case. Pension funds are exempt from subscription tax.

Withholding tax

Distributions by Luxembourg real estate investment funds, whether paid to resident or non-resident investors, are not subject to any Luxembourg WHT. Some payments may however be subject to WHT as a result of application of the EU Savings Directive (as implemented into Luxembourg domestic law).

Due to their tax-exempt status, WHT levied at source on income received by Luxembourg real estate funds, either directly from real estate or from intermediate holding companies is technically not refundable.

Luxembourg real estate funds formed as investment companies may benefit from certain double taxation treaties signed by Luxembourg, and as a consequence from reduced WHT rates.

Luxembourg real estate funds formed as FCPs will generally not benefit from double taxation treaties unless the unit-holders themselves are able to claim the reduced rate under the applicable DTT. The latter implies significant administrative burdens and is therefore rare in practice.

VAT

Based on established Luxembourg VAT administrative practice, Luxembourg regulated funds as well as AIFs are considered as VATable persons carrying out VAT exempt operations without being entitled to recover input VAT incurred on expenses. They are released from the obligation to be VAT registered in Luxembourg, unless they are liable to declare and pay Luxembourg VAT on services (or goods under certain conditions) received from foreign suppliers. In that case, they could request a VAT registration under the simplified VAT regime (ie, filing of annual short-form VAT returns).

A notable exception applies in this general practice to vehicles owning and letting immovable property subject to VAT (option to tax). The normal VAT regime (ie, filing of periodic and annual long-form VAT returns) would apply in this case.

In the case of FCPs, the latter cannot VAT register in Luxembourg. Any VAT liability arising for them on services purchased from foreign suppliers must be declared in the VAT return of the FCPs management company.

The management of regulated investment vehicles as well as AIFs is exempt from VAT.

Taxation of investors

Resident private investors
Luxembourg resident private investors are taxed on distributions (including interest and dividends if any) by a Luxembourg real estate SICAV or FCP at a rate that depends on both their total taxable income and their family status.

Capital gains realised at the time of the sale of SICAV shares or FCP units by such Luxembourg residents should be tax-exempt where the shares/units have been held for a period exceeding six months, and the holding does not qualify as substantial (ie, more than 10% of the fund) for tax purposes. Where these conditions are not met, capital gains are taxable at a rate that depends on the taxpayer's situation.

Resident corporate investors
Distributions and capital gains derived by resident corporate investors from their investments in a SICAV or through their investments in FCP units are subject to CIT and municipal business tax in Luxembourg, as they are deemed to be part of the commercial profit of the investor.

Non-resident private/corporate investors
Dividends received by non-resident investors are not taxed in Luxembourg, and the capital gains earned by non-resident investors are only taxed in Luxembourg in the situations previously described (see section "*Investment in a property company by an individual*" or "*Investment in a property company by a holding company*").

Furthermore, the recipient of the income may be liable for tax in the recipient's state of residence.

As mentioned above, a SICAV or FCP may not benefit from the provisions of DTTs.

Real Estate venture capital companies (SICAR)

Regulatory aspects of the SICAR

The Law of 15 June 2004 (the "SICAR Law"), as amended, introduced the SICAR as a specific form of investment vehicle exclusively dedicated to investments in risk capital and reserved to well-informed investors (defined in the same way as under the SIF Law).

By definition, SICARs do not have to comply with any kind of risk diversification requirements and may, in principle, invest 100% of their assets in only one target investment.

The SICAR Law specifies that investment in risk capital refers to the capital provided directly or indirectly to entities in view of their launch, development or listing on a stock exchange and with the aim of offsetting the high level of risks taken by the investors with higher returns.

CSSF Circular 06/241 dated 5 April 2006 gives a general description of the concept of risk capital, and specifies, inter alia, the conditions under which SICARs can be used for real estate structures:

- The real estate investments need to have risk capital characteristics to be classified as eligible assets;
- The SICAR cannot invest directly in real estate, but can do so indirectly through entities holding eligible real estate assets;
- The purpose of the SICAR as a real estate investment vehicle is to bring a development (ie, creation of value) at the level of the underlying real estate object (as further described below).

In fact, the mere fact that real estate assets can present a particularly high risk or are located in countries with a certain political risk does not in itself suffice to prove the characteristic of risk capital.

Whether the real estate investment qualifies as risk capital depends on the type of investment and its expected yield. So-called opportunistic investment strategies are acceptable in principle, while core-plus investments will be analysed on a case-by-case basis. Core investments are, in principle, not eligible.

The creation of a SICAR whose policy would, for example, be limited to the holding or the management, through a SICAR, of family, corporate or group properties, is not eligible.

The type of structure, which could be considered eligible, might include the following characteristics:

- The objective of developing the target asset (for example value creation through investment in renovating a property or restructuring of a portfolio of properties);
- A specific element of risk associated with the property which is beyond the common level of a real estate risk (ie, the location of the property in a distressed area or an emerging market or country or a property with significant tenant or void risk);
- The objective of acquiring the property in order to sell at a capital gain.

The main regulatory criteria, which apply to a real estate SICAR, are listed below.

Main regulatory features SICAR	
Eligible investors	well-informed investors
Legal forms available	• public limited company (S.A.); • private limited company (S.à r.l.); • corporate partnership limited by shares (S.C.A.); • limited partnership (SCS); • special limited partnership (SCSp); • cooperative company organised as a public limited company (SCoopSA)
Licensing requirements	SICARs must receive the CSSF's prior authorisation before they can start their activities. The managers, the auditor and the custodian are also subject to the CSSF's pre-approval, but there is no such requirement for the promoter and the investment manager of the SICAR. In addition, the CSSF requires, inter alia, a business plan with a risk analysis, as well as a description of the governance structure.
Minimum capital requirement	Subscribed share capital including share premiums must reach 1 million EUR within twelve months of authorisation. At least 5% of each share must be paid up at subscription. A SICAR may opt for variable or fixed share capital.

Compulsory service providers in Luxembourg	• depositary: responsible for safekeeping the SICAR assets, must be a Luxembourg bank or a Luxembourg branch of an EU bank • central administration: must be a Luxembourg bank or a Luxembourg branch of an EU bank or a professional of the financial sector with a proper license • external auditor
Minimum frequency of NAV calculation	once a year

A key element of a SICAR is that it can create multiple investment compartments and can issue different classes of shares, in the same way as investment funds.

Particular tax implications

Taxation of the SICAR entity
The applicable taxation regime depends on the legal form of the SICAR. The SICAR in the form of a limited partnership (SCS) is deemed to be transparent for CIT purposes and exempt from municipal business tax. Taxation will consequently be levied at the level of partners according to the rules applicable in their country of residence.

A SICAR, which has adopted a corporate form, is fully liable to taxation in Luxembourg. However, income and capital gains derived from "securities" are excluded from the taxable basis. This treatment additionally applies to temporary investments in liquid assets held for a period of maximum 12 months before investment in capital risk.

The preliminary works on the SICAR Law provide a definition of "securities" in the sense of the SICAR Law. This definition is broad and includes bonds, loans and any other trade able securities as well as interests in underlying real estate funds or other entities owning real estate directly or indirectly.

Any other income is included in the taxable basis of the SICAR (eg, interest income on undistributed funds, royalties) and thus subject to the general provisions of the LITL.

The SICAR is liable to the minimum net wealth tax.

Withholding tax
Distributions by a SICAR, whether paid to resident or non-resident investors, are not subject to any Luxembourg WHT. Some payments may however be subject to WHT in application of the EU Savings Directive.

The Luxembourg tax authorities have confirmed that they consider the SICAR as being a Luxembourg tax resident for DTT purposes. Income paid by foreign entities to the SICAR should therefore benefit from reduced WHT rates according to the appropriate DTT in place between Luxembourg and the source country. This equally applies to the EU Parent-Subsidiary Directive benefits.

However, the SICAR also need to be recognised as a Luxembourg resident by the tax authorities of the source owning. One may expect some questions to be raised by these foreign tax administrations regarding the application of the DTT, due to the specific regime (ie, exemption of certain income) applied to a Luxembourg SICAR.

WHT levied at source (at a reduced rate or at the normal rate) on exempt income received by a Luxembourg SICAR is normally not refundable. According to Luxembourg tax credit rules, the creditable amount is limited to the amount of Luxembourg tax that would have been levied on this income. Income from securities being tax-exempt in the hand of the Luxembourg SICAR, any related foreign WHT will generally not offset any Luxembourg tax.

Dividends paid by a Luxembourg taxable company to a SICAR benefit from the WHT exemption under the general conditions of the Luxembourg tax regime. This applies accordingly to the income tax exemption on income paid by a SICAR to another Luxembourg company.

It is open to question whether other EU Member States will accept to grant their income tax exemptions under local provisions for dividends paid by a SICAR to a company established in that other EU Member State.

VAT
Based on established Luxembourg VAT administrative practice, Luxembourg SICARs are considered as VATable persons carrying out VAT exempt operations without being entitled to recover input VAT incurred on expenses. They are released from the obligation to be VAT registered in Luxembourg, unless they are liable to declare and pay Luxembourg VAT on services (or goods under certain conditions) received from foreign suppliers. In that case, they could request a VAT registration under the simplified VAT regime (ie, filing of annual short-form VAT returns).

A notable exception applies in this general practice to SICARs owning and letting immovable property subject to VAT (option to tax). The normal VAT regime (ie, filing of periodic and annual long-form VAT returns) would apply in this case.

The management of SICARs is exempt from VAT in Luxembourg.

Real estate securitisation structures

Regulatory aspects

The definition of “securitisation” given by the Luxembourg Law of 22 March 2004 on securitisation (the “Securitisation Law”) is very broad. It encompasses all transactions wherein a securitisation vehicle acquires or assumes (directly or indirectly), any risk related to claims, other assets, or obligations assumed by third parties, or inherent to all or part of the activities of third parties and issues transferable securities (shares, bonds or other securities) whose value or yield depends on such risks.

This is a wider definition than the one provided by the EU Securitisation Regulation 2017/2402, under which “securitisation” refers only to transactions comprising credit risk and issuance of subordinated tranches of financing instruments.

The Securitisation Law allows a wide range of assets, such as tangible or intangible assets or activities with a reasonably ascertainable value or predictable future stream of revenue to be securitised, which creates multiple possibilities for real estate structuring. The transactions can be arranged by transferring the legal ownership of the assets (“true sale”) or by transferring credit risks linked to the assets (“synthetic”).

To qualify as a Luxembourg securitisation vehicle governed by the Securitisation Law, entities must specifically state in their articles of incorporation or management regulations (for securitisation funds) that they are subject to the provisions of the Securitisation Law.

Modelled on the Luxembourg investment fund regime, the Securitisation Law introduced securitisation vehicles in the form of corporate entities, as well as in the form of securitisation funds managed by a management company and governed by management regulations.

Securitisation companies may take the legal form of a S.A., a S.à r.l., a S.C.A. or a cooperative company organised as an S.A. (SCoopSA). One of the main advantages offered by the securitisation vehicle regime is the possibility of creating several compartments within one single entity, just as with an “umbrella fund” vehicle. The articles of incorporation of the securitisation company must simply authorise the Board of Directors/Managers to create separate compartments. The compartments allow for the separate management of a pool of assets and corresponding liabilities, so that the result of each pool is not influenced by the risks and liabilities of other compartments. Each compartment can be created and liquidated separately by simply Board decision.

A securitisation vehicle can also be organised in a purely contractual form as a securitisation fund. In the absence of legal personality, the securitisation fund will be managed by a management company, which will be a commercial company with legal personality (it does not have to be a Chapter 16 management company). The securitisation fund may also be split into sub-funds, which may be liquidated separately.

Securitisation vehicles do usually not qualify as alternative investment funds (AIFs) within the meaning of the 2013 Law. This is the case if the securitisation vehicle:

- meets the definition of a "securitisation special purpose entity" under the 2013 Law, ie, its sole purpose is carrying on securitisation in the meaning of Regulation (EC) No 24/2009 of the European Central Bank (the "ECB Regulation"). This means that assets have to be transferred to an entity that is separate from the originator for the purpose of the securitisation and/or the credit risk of the assets is transferred to the investors in the securities issued. Therefore, securitisation vehicles originating loans or issuing structured products (synthetic exposure to non-credit-related assets) would not per se benefit from this exemption while collateralised loan obligations do;
- only issues debt instruments;
- is not managed according to an "investment policy" within the meaning of Article 4(1)(a) of the 2013 Law; or
- issues structured products, based on a preestablished formula, which may be considered as not being managed according to an "investment policy".

A securitisation vehicle is subject to mandatory CSSF supervision only if it issues securities to the public on a continuous basis (“authorised securitisation undertaking”, as defined under Article 19 of the Securitisation Law). In all other cases, the securitisation vehicle is not subject to any direct regulatory supervision. Broadly speaking, issues to professional investors, denominations exceeding 125,000 EUR and private placements are not considered as issues to the public. Regarding the notion “on a continuous basis”, the CSSF considers it to be fulfilled from the moment the securitisation undertaking makes more than three issues per calendar year to the public.

The "public" nature of the issues will be assessed in particular in connection with the target public to which the issued securities are offered and/or distributed. The securitisation undertaking offering its securities or the entities

which distribute them to or place them with investors, where appropriate, must ensure that they comply with all the legal provisions applicable in the different jurisdictions, and in particular those in respect of "offers to the public".

The assessment of the authorisation requirement must, where appropriate, reflect the distribution systems implemented for the issued securities ("look-through approach"). Indeed, certain securities may be offered to the general public on a continuous basis through distribution channels specifically aimed at retail investors.

Authorisation by the CSSF means that the CSSF would have to approve the articles of incorporation or management regulations of the securitisation vehicle and, if necessary, authorise the management company.

Other regulatory obligations would include:

- Securitisation companies and management companies of securitisation funds must have an adequate organisation and adequate resources to exercise their activities.
- The directors (at least three directors) of the securitisation company or the management company of a securitisation fund must be of good repute and have adequate experience and means required for the performance of their duties.
- Structuring and management of the assets may be delegated to other professionals in Luxembourg or abroad; however, in such a case, an appropriate information exchange mechanism between the delegated functions and the Luxembourg based administrative body must be established and in particular the external auditor and the CSSF must be allowed to exercise their supervisory tasks.
- The CSSF supervises regulated securitisation vehicles on a continuous basis.

However, today's most common types of real estate securitisation vehicles are unregulated.

The Securitisation Law offers an attractive regulatory framework for setting up workable real estate securitisation structures in Luxembourg at reasonable costs. Securitisation vehicles are in particular interesting for infrastructure investments or for any not actively managed portfolio, ie, certain illiquid investments. Active management of the assets of a securitisation vehicle or acting as an entrepreneur would not be explicitly allowed under the Securitisation Law. Therefore, the direct securitisation of a real estate property needs to be analysed beforehand. Most common is the securitisation of loans to property companies, often collateralised by the property itself.

Depending on the investor's needs, each property could be represented by a separate compartment, a solution which is not possible using another real estate vehicle. Furthermore, compartment segregation prevents insolvency contamination, which is one of the most important aspects of the Securitisation Law. The principle of bankruptcy remoteness separates the securitised assets from any insolvency risks of the securitisation vehicle or of the originator, the service provider or collateral. In addition, the Securitisation Law provides for the assets to be exclusively available to satisfy the claims of the investors who funded them and of the creditors whose claims are linked to their assets.

Particular tax implications

Taxation of the securitisation vehicles
Securitisation vehicles organised as corporate entities are fully liable to CIT and municipal business tax.

According to the Securitisation Law however, the commitments of a securitisation company to remunerate investors for issued bonds or shares and other creditors qualify as interest on debt even if paid as return on equity. Hence, they are fully tax-deductible. The resulting tax neutrality is one of the key success factors of Luxembourg securitisation structures.

Regarding WHT, comments made in relation to the SICAR apply, as the regime is similar.

Securitisation vehicles are subject to the minimum net wealth tax.

VAT
Based on established Luxembourg VAT administrative practice, Luxembourg securitisation vehicles are considered as VATable persons carrying out VAT exempt operations without being entitled to recover input VAT incurred on expenses. They are released from the obligation to be VAT registered in Luxembourg, unless they are liable to declare and pay Luxembourg VAT on services (or goods under certain conditions) received from foreign suppliers (ie, filing of annual short-form VAT returns).

A notable exception applies in this general practice to vehicles owning and letting immovable property subject to VAT (option to tax). The normal VAT regime (ie, filing of periodic and annual long-form VAT returns) would apply in this case.

The management of Luxembourg securitisation vehicles is exempt from VAT in Luxembourg.

Real estate leasing contracts

General

Leasing companies are not considered as credit institutions, insofar as they do not collect deposits or funds from the public.

Consequently, leasing companies in principle do not need a licence from the Luxembourg Central Bank (LCB) for carrying out their activity, nor do they fall under the supervision of the LCB. However, they will have to file a specific request to exercise this activity with the Ministry of Small Businesses (*Ministère des Classes Moyennes*). Some exceptions may apply within the framework of intra-group transactions.

Legal framework

The law does not contain a definition of a lease contract. All lease contracts are basically treated as rental agreements under Article 1710 of the Civil Code. The lessor conveys to the lessee, in return for rent, the right to use an item of property for an agreed period of time. At the expiration of the period, the contract may offer the lessee the opportunity to acquire the leased asset.

This is confirmed by several Luxembourg Supreme Court decisions. A decision of the Court in 1977 provided the following analysis of the legal nature of a leasing contract under commercial and civil law.

It is important to stress that, from an economic and financial point of view, a leasing/credit operation can be described as follows: a specialised financing company acts on behalf of entrepreneurs who are looking for equipment without the necessity of having to bear the initial price of acquisition. The entrepreneur makes the choice of the equipment needed; the leasing company substitutes itself for him in buying the equipment and renting it to the entrepreneur. The leasing agreement is concluded for a term sufficient for the lessor-owner to recover the value of the leased asset. The leasing agreement distinguishes two periods: the primary period, called the irrevocable period, which has a duration close to the tax depreciation period; and the second period, the residual period, which continues until the extinction of the economic life of the equipment.

At the expiration of the first period, the entrepreneur-lessee is granted an option either to return the equipment to the lessor-owner or to acquire the asset at its minimum residual value or to go on with the leasing at reduced rentals in respect of the residual value.

Categories of leasing contracts

Financial leasing contracts

A financial leasing is a full-payout leasing contract, ie, the lease payments payable to the lessor during the irrevocable term cover the acquisition and manufacturing costs of the asset and all incidental expenses, including the lessor's financing costs.

Operating leasing contracts

An operating leasing is considered as an ordinary rental agreement, with the following characteristics:

- In general, the agreement may be cancelled at any time.
- The risk of an increase or decrease in value for economic or technical reasons, insurance premiums, and the repair and maintenance costs of the asset are mainly borne by the lessor.

Non-full-payout leasing contract

A non-full-payout contract can be cancelled after a predetermined period. The leasing payments made during the lease term only cover a part of the purchase price and all incidental expenses and the lessor's financing costs.

Attributes of the leased assets

Legal ownership

The law does not provide a definition of a lease contract. All lease contracts are basically treated as rental agreements under Article 1710 of the Civil Law, ie, the lessor conveys to the lessee the right to use an item of property for an agreed period of time in return for rent.

Economic ownership

The economic ownership of the asset is attributed to the lessor or the lessee depending on the terms of the contract. From an accounting and tax viewpoint, economic ownership is the relevant element in determining whether the real estate is attributed to the lessee or the lessor. The attribution of economic ownership is based on German case law.

Particular tax implications

One of the key principles of Luxembourg tax law is that it follows the accounting rules, unless tax law provides for other rules. Regarding leasing contracts, as no specific accounting rules exist in Luxembourg, tax law is usually followed for accounting purposes, and therefore the attribution of the subjects of the leasing as referred to above is of prime importance.

Corporate income tax

Asset attributed to the lessor

The lessor capitalises the leased asset as a fixed asset in its balance sheet and depreciates it according to its economic lifetime. The annual lease payments are treated as taxable profit to be booked in its profit and loss account.

The leasing payments are treated as operating expenses, which are tax-deductible, in the lessee's profit and loss account.

Asset attributed to the lessee

From the lessor's point of view
The lessor records the minimum leasing payments in its balance sheet as a receivable (ie, the payments over the leasing term that the lessee is or can be required to make, without the costs for services and taxes to be paid by and reimbursable to the lessor). The annual leasing payments are broken down into a refund of capital and an interest component. The interest will be treated as taxable profit in the lessee's profit and loss account.

From the lessee's point of view
First, the lessee capitalises and depreciates the leased asset in its balance sheet. Then, it records a corresponding liability for the future leasing payments. The leasing payments have to be apportioned into an interest and a capital portion. The interest portion is treated as an operational expense in the profit and loss account of the lessee. The capital portion will reduce the liability.

Municipal business tax

There is no particular tax treatment for municipal business tax.

Net wealth tax

Asset attributed to the lessor

The lessor has to add the unitary value of the leased building to its net wealth taxable basis. Until the lessee exercises any call option stipulated in the leasing contract, the lessor has to report the unitary value of the leased building in its net wealth taxable basis.

Asset attributed to the lessee

The lessee has to add the unitary value of the leased building to its net wealth taxable basis. It can deduct from this taxable basis the lease payments not yet paid at the time the unitary value is fixed. This deduction includes the amount related to any call option to be exercised at the end of the primary leasing period.

The lessor has to include in its own net wealth taxable basis an amount corresponding to the leasing payments not yet paid.

VAT

As a general rule, the leasing of an existing property located in Luxembourg is exempt from Luxembourg VAT. Accordingly, the landlord is not entitled to recover input VAT incurred on related expenses.

The landlord may however opt to VAT to the extent that the option conditions are met. In consequence, input VAT incurred on related expenses is recoverable.

Registration duty

Since October 2016, lease agreement must no longer be registered. However, in case a lease is registered in Luxembourg, the following registration duties are levied.

The letting of property is subject to a registration duty of 12 EUR if VAT applies on the rent (ie, if a valid option is obtained).

Leases not subject to VAT are in principle subject to a registration duty of 0.6%. The taxable amount is the aggregate amount of the rental fees over the term of the lease.

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All information used in this content, unless otherwise stated, is up to date as of 11 August 2020.

Real Estate Tax Summary

General

The coordination and regulation of the acquisitions of assets, including real property by foreign interests, is undertaken by the Economic Planning Unit (EPU) in the Prime Minister's department through the issuance of guidelines. Compliance with the guidelines is expected. Non-residents may invest in Malaysian property by direct ownership, or through Malaysian incorporated companies or real estate investment trusts (REITs).

Approval from the EPU will be required for the following situations:

- direct acquisitions of property valued at 20 million Malaysian ringgit (MYR) and above, resulting in the dilution of Bumiputera interests in the property.
- direct acquisitions of property valued at 20 million MYR and above, resulting in the dilution of government agency in the property.
- indirect acquisitions of property by non-Bumiputera interest through the acquisition of shares, resulting in a change of control of the company owned by Bumiputera interest and/or government agency. This is on the basis that the property held by the company is more than 50% of its total assets and the property is valued at more than 20 million MYR.

The property transactions by foreign interest, which fall under the purview of the relevant Ministries and/or Government Departments include (but are not limited to):

- the acquisition of industrial land or commercial units valued at more than 1 million MYR and must be registered under a locally incorporated company and are subject to prescribed conditions; and
- the transfer of property to a foreigner based on family ties which is only allowed among immediate family members.

Acquisitions of land for property development projects, such as housing or commercial property projects, must be made by a Malaysian-incorporated company, among other prescribed conditions.

Real estate investment trust (REIT)

The Securities Commission (SC) issued guidelines on REITs to accelerate growth and establish a vibrant and competitive real estate investment trust industry in Malaysia.

Malaysian REITs are trusts governed by general trust law. A trust is not a separate legal entity or person. It is a set of obligations accepted by a person (the trustee) in relation to the property (the trust property), in which such obligations are exercised for the benefit of another person (the beneficiary). The obligations of the trustee and the rights of the beneficiaries are typically set out in writing in the trust deed. In addition, the trustee has a legal duty to act in the best interests of beneficiaries, to act honestly and to exercise the same prudence and diligence as an ordinary person would exercise in carrying on their own business.

Malaysian REITs are similar to that of a unit trust; that is, all income and capital entitlements of the trust are fixed in accordance with the trust deed, and those entitlements are unitised. Income and capital entitlements of a beneficiary (or unitholder) are determined by reference to the number of units they hold, and the rights attached to those units per the trust deed. Similar to a shareholder's liability in a company, a unitholder's liability is also limited, although the law is not explicit on this.

The REIT must also appoint a trustee that is approved by the SC. The trustee must be a trust company registered under the Trust Companies Act 1949 or incorporated under the Public Trust Corporation Act 1995, registered with the SC and have a minimum issued and paid-up capital of not less than 500,000 MYR.

The trustee of a Malaysian REIT holds the real estate or properties in a REIT portfolio in trust for the REIT investors. Malaysian REITs are managed by management companies that have to be approved by the SC.

Under the guidelines, only a management company approved by the SC can act as a management company to a REIT. The management company must:

- be an entity incorporated in Malaysia;
- (except where the management company is licensed by the SC), be a subsidiary of:

  - a company involved in the financial services industry in Malaysia;
  - a property development company;
  - a property investment holding company; or
  - any other institution which the SC may permit;
- have a minimum of 30% local equity; and
- have minimum shareholders' funds of 1 million MYR at all times.

The initial minimum size of a REIT should be at least 100 million MYR. A REIT is required, as part of its listing scheme, to undertake an offering to the general public. Any expenses incurred relating to an offer for sale of units shall be borne by the offeror.

A REIT may only invest in real estate, single-purpose companies, real estate-related assets, non-real estate-related assets, cash, deposits and money market instruments. At least 50% of the fund's total asset value must be invested in real estate and/or single-purpose companies at all times. The fund's investment in non-real estate-related assets and/or cash, deposits and money market instruments must not exceed 25% of the fund's total asset value.

The SC recently issued new guidelines on listed REITs on 15 March 2018. A listed REIT may only invest in real estate, non-real estate-related assets and cash, deposits and money market instruments. At least 75% of the fund's total asset value must be invested in real estate that generates recurrent rental income at all times.

A listed REIT may invest in real estate where it does not have a majority ownership and control provided that the total value of these real estate does not exceed 25% of the listed REIT's total asset value at the point of listing or acquisition and it is in the best interest of unit holders.

A listed REIT may also invest in a real estate through a lease arrangement, provided that the management company ensure the following:

- where the lease relates to a real estate located in Malaysia, the lease must be registered with the land authority;
- where the lease relates to a real estate located outside Malaysia, the lease must be registered or recognised by the relevant land authority under a land registry framework equivalent to that of Malaysia;
- the listed REIT has the relevant rights, interests and benefits (including the right to sub-lease) related to the listed REIT's interests as a lessee of the real estate;
- the total value of investment through a lease arrangement, where the real estate having remaining lease period of less than 30 years must not exceed 25% of the listed REIT's total asset value at the point of listing or acquisition, as the case may be; and
- the interests of unit holders of the listed REIT are protected with respect to the risk relating to the listed REIT not being the registered proprietor of the real estate. Legal opinion must be obtained for this purpose.

A listed REIT may invest in real estate under construction, provided that:

- the arrangement or agreement to acquire the real estate under construction is made subject to the completion of the building with sufficient cover for construction risks;
- the arrangement or agreement to acquire the real estate under construction must be on terms which are the best available for the REIT and which are no less favourable to the REIT than an "arm's length" transaction between independent parties; and
- the prospects for the real estate to be acquired upon its completion are reasonably expected to be favourable.

The aggregate investments in property development activities (Property Development Costs) and real estate under construction must not exceed 15% of the REIT's total asset value.

A REIT may acquire real estate located outside Malaysia subject to the approval of the SC.

Exchange control rules

Subject to the EPU guidelines, a non-resident is free to obtain any amount of Malaysian ringgit borrowings from licensed onshore banks (excluding licensed international Islamic banks) to finance activities in the real estate sector in Malaysia, or finance/refinance the purchase of residential and commercial properties in the Malaysia, except for the purchase of land only.

Non-residents are also free to purchase any ringgit assets and free to repatriate funds from divestments in ringgit assets or profits/dividends arising from the investments. Repatriation however must be in foreign currency other than the currency of Israel.

Effective 3 December 2014, the following relaxations have also been accorded to resident companies wishing to obtain financing.

Foreign currency borrowings

A resident company is free to borrow any amount in foreign currency from:

- resident or non-resident direct shareholders;
- resident or non-resident entities within its group of entities;
- licensed onshore banks[1]; or
- another resident through the issuance of foreign currency debt securities.

A prudential limit of 100 million MYR equivalent in aggregate is applicable to borrowing by resident entities from non-resident financial institutions and other non-residents which are not part of its group of entities

A resident company is free to refinance outstanding approved foreign currency borrowing, including principal and accrued interest.

Ringgit borrowings

A resident company is allowed to borrow in ringgit:

- of any amount from its non-resident entities within its group of entities and their non-resident direct shareholders to finance activities in the real sector[2]; in Malaysia;
- up to 1 million MYR in aggregate from any other non-resident, other than a non-resident financial institution, for use in Malaysia.

Rental income

General

In general, income accruing in or derived from Malaysia (net of tax deductible expenses and capital allowances) is taxed at the current prevailing corporate tax rate of 24% unless specific exemptions apply.

Rental income derived from properties situated in Malaysia is subject to income tax and may be taxed as business income or investment income, depending on the circumstances in each case. Letting of real property is deemed as a business source if maintenance services or support services are comprehensively and actively provided in relation to the real property.

Maintenance services or support services comprehensively provided refers to services including:

- doing generally all things necessary (eg, cleaning services or repairs) for the maintenance and management of the real property such as the structural elements of the building, stairways, fire escapes, entrances and exits, lobbies, corridors, lifts/escalators, compounds, drains, water tanks, sewers, pipes, wires, cables or other fixtures and fittings; and
- doing generally all things necessary for the maintenance and management of the exterior parts of the real property such as playing fields, recreational areas, driveways, car parks, open spaces, landscape areas, walls and fences, exterior lighting or other external fixtures and fittings.

If a person only provides security services or other facilities, that person is not providing maintenance services or support services comprehensively. Such services may be provided by the person himself who owns or lets out the real property or by another person or firm hired by him. Hence, rental income is treated as business income.

Expenses which are allowed a deduction is the direct expenses that is wholly and exclusively incurred in the production of income such as assessment and quit rent, interest on loan (taken to finance purchase of real property rented out), fire insurance premium, expense on rent collection and rent renewal, and repairs.

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1 Licensed onshore banks refer to licensed commercial banks, licensed Islamic banks and licensed investment banks.

2 Real sector is the sector where there is production of goods and services, which includes all industries except for financial services.

Capital allowances can also be claimed on qualifying expenditure incurred on certain types of buildings as well as plant and machinery used in the business.

Costs that are capital in nature, such as stamp duty and legal costs incurred on the acquisition of property, are not tax-deductible, but would be regarded as forming part of the acquisition price of the property for real property gains tax (RPGT) purposes.

Notwithstanding the above, there's a special treatment provided for letting of a building to an approved Multimedia Super Corridor (MSC)[3] status company, which are regarded as carrying on a business and the income received therefrom is considered as a business income.

Without the comprehensive and active provision of maintenance services or support services, the letting of real property is deemed as a non-business source where rental income is treated as investment income and the rules provide for different types of deductions.

REIT

Rental income from the letting of real property received by REIT is to be treated as business income, and expenses incurred wholly and exclusively in the production of such gross rental income is deductible against business income. Business deductions can include management fees, interest and taxes, and the REIT manager's remuneration. However, a trustee fee does not qualify for tax deduction, since it is not wholly and exclusively incurred in the production of gross income.

Expenses incurred to set up an entity are not allowed as a tax deduction as these expenses are regarded as pre-commencement expenses. However, as an incentive, the Income Tax (Deduction for Establishment Expenditure of Real Estate Investment Trust or Property Trust Fund) Rules 2006 provide that the legal, valuation and consultancy fees incurred for establishing a REIT, which is subsequently approved by the SC, will be allowed as a tax deduction when the business of the REIT commences.

The undistributed income of the REIT will be subject to normal corporate income tax, currently at 24%. Due to new tax transparency legislation, distributed income by REIT will not be taxed at REIT level, provided that the REIT distributes 90% of its income. Instead, the unitholders will be taxed on such distributions received. For more details, see section "*Taxation of REITs*".

Depreciation and capital allowance for industrial buildings

Depreciation of land and buildings does not qualify for tax deduction against rental income.

Where a building is classified as an industrial building (eg, factory, warehouse, etc), and it is used for business or leased to a tenant who uses the premise as an industrial building, a capital allowance known as an industrial building allowance (IBA) can be claimed against the business or rental income of the owner of the building. Generally, the initial allowance is 10%, and the annual allowance is 3% of the building cost. A REIT that rents out its building will only qualify for IBA if the tenant uses the building as an industrial building. The buildings leased out which do not qualify for IBA include hospital, nursing home, research, warehouse for export and imported goods, approved service projects, hotels, airports, motor racing circuits, school, educational institution or living accommodation for individuals.

Capital allowances may be claimed on qualifying capital expenditures incurred on plant and equipment used in a business of letting property. The initial allowance is 20%, and the annual allowance varies depending on the type of plant and equipment used. The rates of annual allowance are as follows:

Type of plant and equipment used	Rate of annual allowance (in %)
Office equipment	10
Furniture and fittings	10
General plant and machinery	14
Heavy machinery and motor vehicles	20
Environmental protection equipment	20
Computer and information technology assets	20

[3] MSC or MSC Malaysia encompasses an integrated environment that encourages innovation, helps local and international companies to reach new technological frontiers, promotes partnership with global IT players and provides opportunities for mutual enrichment and success.

Motor vehicle (private passenger car type)[4]	20

Accelerated capital allowances are eligible for certain plant and equipment.

Expenditure on assets with life span of no more than two years is allowed on a replacement basis.

In general, capital allowances on qualifying plant expenditure can only be claimable against business income and not investment income. As such, only rental income treated as business income will be entitled to the relief of capital allowances.

In relation to a REIT, where there is insufficient adjusted income to absorb the capital allowances for that year of assessment, the unused capital allowances shall be disregarded and will be permanently lost.

Costs of obtaining finance

Costs of obtaining finance (other than interest), including legal costs and stamp duty on new loan transactions, are generally not deductible. However, specific tax deduction is given for financing costs incurred in relation to the issuance of certain Islamic securities/bonds up to year of assessment 2010. This incentive has been extended for another five years, until year of assessment 2015, and subsequently until year of assessment 2020.

Capital gains on sale of real property

Any gains on disposal of real properties (chargeable asset), or shares in real property companies (chargeable asset) would be subject to the following RPGT rates:

	RRPT rate (in %)		
Date of disposal	Companies	Individual (citizen & permanent resident)	Individual (non-citizen)
Within three years from date of acquisition	30	30	30
In the 4th year	20	20	30
In the 5th year	15	15	30
In the 6th year and subsequent years	10	5	10

A real property company is a controlled company that owns or acquires real property or shares in real property companies with a market value of not less than 75% of its total tangible assets. A controlled company is a company that does not have more than 50 members and is controlled by not more than five persons.

Where the disposal of property is by a property owner to a REIT approved by the SC, exemptions from RPGT and stamp duty have been provided. This exemption applies only to acquisitions of properties by an approved REIT. Where the approved REIT subsequently sells properties, the RPGT and stamp duty exemption would not apply.

Dividends

The tax on a company's profits is a final tax, and the dividends distributed to its shareholders are exempt from tax. This would mean that where the dividends received from a Malaysian company are single-tier dividends or tax-exempt dividends, no further tax will be payable by the REIT. Due to tax transparency, single-tier dividend income or tax-exempt dividend income earned by the REIT will retain its character when distributed to unitholders, so that no withholding tax (WHT) should apply when it is distributed to the investors.

Taxation of REITs

The Inland Revenue Board of Malaysia (IRBM) has issued the following Public Rulings in relation to REITs:

- Public Ruling No 5/2017 "*Taxation of Real Estate Investment Trust or Property Trust Fund*"; and
- Public Ruling No 8/2012 "*Real Estate Investment Trusts/Property Trust Funds – An Overview*".

[4] Motor vehicles excluding motor vehicles licensed for commercial transportation of goods or passengers are subject to a restriction on the maximum qualifying expenditure: new vehicles purchased on or after 28 October 2000 where on-the-road price is 150,000 MYR or less subject to a maximum qualifying expenditure of 100,000 MYR; and vehicles other than the above is subject to a maximum qualifying expenditure of 50,000 MYR.

Generally, the income of a REIT consisting of rental income, interest (other than interest which is exempt from income tax) and other investment income derived from or accruing in Malaysia will be taxable at the normal corporate tax rate currently at 24%.

REITs listed on Bursa Malaysia are not taxable as they have a "flow through" tax status or tax transparency status provided they meet certain requirements.

Where a listed REIT distributes at least 90% of its income, the tax transparency rules will apply so that tax will not be levied at REIT level. A REIT that is not listed on Bursa Malaysia would not enjoy the above tax transparency treatment.

Where a REIT, listed on Bursa Malaysia, intends to distribute 90% or more of its total income but has fallen short of 90% at the end of the basis period, the listed REIT is given a grace period of two months from the closing of its accounts to distribute the balance so as to qualify for tax exemption at the REIT level.

If less than 90% of its total taxable income is distributed in a year of assessment, then the tax transparency system would not apply and total taxable income of the REIT would continue to be taxed, currently at the prevailing rate of 24%. Income, which has been taxed at the REIT level, will have tax credits attached when subsequently distributed to unitholders.

All dividend income received by the REIT from a resident company are not subject to tax in Malaysia.

Exempt income

Since REITs are considered to be unit trusts, certain income is exempt from tax, including interest or discount from the following investments:

- any savings certificates issued by the Government;
- securities or bonds issued or guaranteed by the Government;
- sukuk or debentures issued in ringgit, other than convertible loan stocks, approved or authorised by or lodged with the Securities Commission;
- Bon Simpanan Malaysia issued by the Central Bank of Malaysia (Bank Negara Malaysia); and
- bonds and securities issued by Pengurusan Danaharta Nasional Berhad.

Interest paid or credited by any bank or financial institution licensed under the Financial Services Act 2013 or the Islamic Financial Services Act 2013 or a development financial institution prescribed under the Development Financial Institutions Act 2002 is tax-exempt[5]. Income received by the REIT from overseas investment is also tax-exempt. The income exempted at the REIT level is also exempt from tax upon distribution to unitholders.

Foreign sourced income earned by the REIT is exempted in Malaysia. Foreign sourced income earned by the REIT will retain its character when distributed to its unitholders so that no WHT should apply.

Tax treatment of unitholders

The taxation of unitholders will depend on whether the unitholders are Malaysian residents or non-residents. The tax treatment is also dependent on whether the REIT has distributed 90% or more of its total taxable income and whether the REIT is listed on Bursa Malaysia.

The REIT distributes 90% or more of taxable income

Where 90% or more of the listed REIT's total taxable income is distributed by the listed REIT, distributions to unitholders will be subject to tax based on a WHT mechanism at the following rates:

Unitholders	WHT rate (in %)
Individuals and all other non-corporate investors such as institutional investors (resident and non-resident)	10[6]
Non-resident corporate investors	24
Resident corporate investors	0

[5] With effect from 1 January 2019, the exemption shall not apply to interest income/profit income paid or credited to a unit trust that is a wholesale money market fund.

[6] This reduced rate of WHT is effective from 1 January 2009 to 31 December 2025.

The WHT is a final tax and resident individuals and non-corporate investors will not be required to declare the income received from the listed REIT in their Malaysian tax returns.

No WHT is applicable on distributions to resident corporate investors. Resident corporate investors are required to report the distributions from the listed REITs in their normal corporate tax return and bring the taxable listed REIT distributions at the normal corporate tax rate, currently at 24%.

Where a REIT that is not listed on Bursa Malaysia makes any distribution of its total income to its unit holders, this distribution is not subject to withholding tax since an unlisted REIT has to pay income tax at 24%.

The REIT distributes less than 90% of taxable income

Where less than 90% of the total taxable income is distributed, the listed REIT is not entitled to the exemption. The listed REIT would have paid taxes on the taxable income for the year. The distributions made by the REIT of such taxed income will have tax credits attached.

The tax treatment for unitholders would be as follows:

Resident individuals

Resident individuals will be subject to tax at their own marginal rates on the distributions and be entitled to tax credits representing tax already paid by the REIT.

Resident corporate investors

Resident corporate investors are required to report the distributions from REITs in their normal corporate tax return and bring such income to tax at the normal corporate tax rate, currently 24%. Where tax has been levied at the REIT level, the resident corporate investors are entitled to tax credits.

Foreign unitholders

No further taxes or WHT would be applicable to foreign unitholders. Foreign unitholders may be subject to tax in their respective jurisdictions depending on the provisions of their country's tax legislation and the entitlement to any tax credits would be dependent on their home country's tax legislation.

Distributions representing specific exempt income or gains on disposal of investments at the REIT level will not be subject to further income tax when distributed to all unitholders.

Disposals by unitholders

Malaysia does not impose tax on capital gains. Therefore, gains on the disposal of the units by unitholders which are considered to be capital in nature will not be subject to income tax.

If a unitholder has held the units for long-term investment purposes, any gains arising from the disposal of the Units should be considered capital gains and hence, not subject to Malaysian income tax.

However, if the units have been held as trading assets of a trade or business carried on in Malaysia, the gains arising from the sale of units will be seen to be part of business income and subject to normal income tax. Dealers in securities and financial institutions in Malaysia (eg, insurance companies and banks) will normally be subject to income tax since such gains will be seen to be part of their business income. Foreign dealers and financial institutions with no business presence or permanent establishment in Malaysia will not be subject to Malaysian income tax on such gains. Such gains may still be subject to tax in each foreign investors' respective jurisdictions.

In the event of a winding up of REIT, the taxation of gains received in the form of cash or residual distribution will depend on whether the gains are seen to be capital gains or normal business income.

Unitholders electing to receive their income distribution by way of investment in the form of new units will be regarded as having purchased the new units out of their income distribution.

Unit splits issued by REIT are not taxable in the hands of unitholders.

Loss carryforward

Income tax

Losses can only be carried forward for offset against future business income if the losses had been incurred in the course of carrying on a business. As a result, if the leasing of properties qualifies as a business activity for income tax purposes, losses incurred would be available for carryforward.

However, effective year of assessment (YA) 2006, accumulated tax losses and unabsorbed capital allowances of a dormant company shall be disregarded in the event there is a change of more than 50% in the company's direct/immediate shareholdings.

Any losses incurred by a REIT or an investment holding company from the letting of properties cannot be deducted against income from other sources of income in a basis period. In addition, the losses cannot be carried forward to offset against future business income.

Related party transactions and earning stripping rules (ESR)

The Director General of Inland Revenue is empowered to make adjustments to transactions of goods and services between associated persons, including related companies. The Transfer Pricing Audit Framework has been issued by the tax authorities to ensure that controlled transactions comply with the "arm's length" principle, the Malaysian tax laws as well as administrative requirements. If any understatement or omission of income is discovered during the transfer pricing (TP) audit, a penalty will be imposed. However, a concessionary penalty rate may be imposed in a case where a voluntary disclosure was made.

Taxpayers have to prepare contemporaneous TP documentation, (ie, either at the point of developing the inter-company transaction or prior to the submission of the company's tax return). Detailed TP Rules 2012 and Advanced Pricing Arrangement Guidelines 2012 have been issued in May and July 2012.

The TP Guidelines 2012 have been updated to reinforce the existing standards based on current international taxation requirements with effect from 15 July 2017.

Earning stripping rules (ESR) is a new method introduced by the Organisation for Economic Co-operation and Development (OECD) to control excessive deductibility of interest expense on loans between related parties. Key features of ESR are as set out in the table below:

Key features	Description
Commencement date	Basis period for a YA beginning on or after 1 July 2019
Scope	Interest expense in connection with or on any cross-border financial assistance in a controlled transaction granted directly or indirectly to a person
De minimis rules	ESR is not applicable where the interest expense is equal to or less than 500,000 MYR in the basis period for a YA.
Maximum amount of interest deduction	20% of Tax-EBITDA
Carry forward rules	Interest expense which is restricted in a YA can be carried forward and deducted against adjusted income from the business for subsequent YA(s), subject to satisfying the substantial shareholders continuity test.
Interest expense	(i) interest on all forms of debts; or (ii) payments economically equivalent to interest (excluding expenses in connection with the raising of finance)
Financial assistance	Includes loans, interest-bearing trade credit, advance, debt and provision of security or guarantee
Controlled transaction	Finance assistance between "related persons"; ie, between: • persons one of whom has control over the others; or • persons both of whom are controlled by a third person.

Other relevant taxes

Stamp duty

Stamp duty is imposed on a wide range of documents and transactions. The rates vary with the type of document and amount involved. The stamp duty payable for transfer instruments for real property is 1% to 3% of the market value of the property. The stamp duty payable for transfer instruments for shares is 0.3% of the consideration.

Instruments of transfer of real property by any person to a REIT approved by the SC are exempted from stamp duty. The sale of property by the REIT is not exempt, and the purchaser has to pay the stamp duty.

Generally, the purchase and sale of units in a listed REIT are not subject to stamp duty since the units are traded scripless on the Malaysian Stock Exchange.

Assessment and quit rent

A property tax called assessment rates is levied on the gross annual value of property and is payable to the city or town council. Quit rent is a form of land tax, and a nominal amount is payable to the state land office.

Sales and services tax

Effective from 1 September 2018, goods and services tax (GST) has been repealed and replaced by the sales and services tax (SST). Income received by REITs (ie, rental income, interest income and dividend income) will not be subject to service tax while expenses incurred by a REIT such as management fees, trustee fees and other administrative and operating expenses will be subject to 6% service tax.

Digital service tax

Effective 1 January 2020, service tax at 6% will be imposed on digital services provided by both local and foreign service providers. Digital services are defined as services which are delivered or subscribed over the internet or other electronic network and cannot be delivered without the use of IT and the delivery of the service is substantially automated. This could potentially result in certain service providers charging digital service tax to a REIT, resulting in an increase in cost.

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

Introduction

Investment in real estate developments has increased in recent years. Regulations regarding accounting, tax and environmental matters should be considered for these investments. Real estate developers must comply with several regulations that may vary depending on the municipality or state where the real estate is located.

Domestic and foreign investors may invest in property in Mexico through a Mexican company, branch, business trust, a Mexican real estate investment trust (REIT), or through a non-resident entity. This report describes, in general, the tax and legal issues for a typical Mexican real estate investment.

Legal issues of Mexican real estate investments

Types of ownership

In Mexico, there are two types of property: public and private property. Public property is reserved for the Mexican State only, whereas for private property, individuals and/or entities may hold ownership of a real estate property in diverse degrees.

Property

A full degree of property over the real estate is a "real right" (in terms of the Continental law system), ie, persons or entities having a property right over buildings and/or land may use, enjoy and dispose of such goods. Property entitles the owner to use such goods according to their nature and to receive the products (eg, revenues) that derive from such goods but also allows the owner to dispose of them. Property right is considered the paramount right in Mexican law and is never superseded. Property rights are permanent and can be transferred upon the death of the right holder to his or her inheritors.

Co-ownership

Co-ownership is another modality of property rights, through which it is possible to be a holder of a property. Co-ownership is set when the ownership of a property is exercised at the same time by two or more persons, each of whose degree of ownership may differ for each participant, but the sum of these fractions comprises the entire right. Although co-ownership is recognised by law, the trend is not to use this modality because of the great inconveniences associated with it, such as maintenance, use, decision making by the partners, etc, on the same object (ie, property or real estate).

Co-ownership rights impose limitations on co-owners when one of them intends to transfer their right: when a co-owner wants to dispose his share, the other owner has a preference right (*derecho de tanto*) to acquire the right before any third party. The "*derecho de tanto*" is so forceful, that it can even make the intended transfer null.

Condominium

Condominium is a form of ownership whereby the owner has the exclusive ownership of a house, apartment, warehouse, etc, as a private unit of a building and, also, the co-ownership of common areas of the property in proportion to the value of the owned unit. Condominium is usually found to be convenient in Mexico because:

- no co-owners' rights are granted, and therefore there are no limitations if a condominium right owner wants to alienate or burden the private unit.
- the owner of each private unit has his own public deed, confirming a property title.
- state or municipal services are individualised, such as electricity, water supply service, etc.

The Condominium regime in Mexico is subject to its own regulations; for example, a person must meet certain requirements to hold a property in this scenario. Regulations may vary from state to state, since the condominium legislation in Mexico is local. However, in any case, the condominium should be constituted by public deed and it requires registration in the Public Registry of Property of the state where the condominium is built.

Please note that the registration before the public registry is essential to make effective the transfer of property for third parties. Any acquisition deed needs to be recorded before the local state-administered public registry.

The condominium scheme is not constrained only to apartments or houses for residential purposes, but can also be held on warehouses, offices, etc.

Lease

The leasing market is quite well developed in Mexico. As in many countries, lease allows a non-proprietor to use of a property but does not grant ownership. Lease agreements are governed by local laws of each state of Mexico; while general terms do not vary dramatically, local rules and exceptions should be expected. Leasing may be held on buildings for residential purposes or for commercial or industrial use.

Lease contracts must be evidenced in writing. For this agreement, there is no need for a public deed signed before a notary public. Also, registration in the Public Registry of Property is not usually necessary, although local laws may dictate that such a requirement be met and may even limit these contracts to a certain time according to the activity that should be performed at the property.

Usufruct

The usufruct is a form of ownership in which two or more owners share and enjoy the ownership and profits of rights to various degrees.

Usufructuaries have the rights to use and enjoyment of property, which means that they can occupy the goods and they also can receive the products (eg, revenues). On the other hand, the bear owners are those who hold property rights related to the disposal of such goods.

It should be noted that any good that is subject to this modality may not be disposed without the prior consent of both parties.

Other types of ownership

In Mexico, not all property can be acquired by private parties; some lands are attached to certain regimes and their acquisition may be subject to restrictions. Indeed, some lands may not even be subject to private ownership.

Common Lands known as “ejidos” are a good example of these properties. Ejidos are a form of collective property. An Ejido, is a group of individuals, Mexican citizens, who are collectively organised in a sort of entity which has its own assets and legal capacity. Such assets may consist of land, forests and waters and might have been endowed to the Ejido or acquired by it (under any property title).

Use, operation and disposal of such assets is subject to a special regime with specific rules. Organisation and internal management are based on economic democracy. Its main objective is to satisfy the demands of its members through the use and suitability of land crop. This type of ownership is inalienable and indefeasible. Its organisation and internal management are regulated by law and traditions.

Restrictions

The Mexican Constitution and the Foreign Investments Law set restrictions on foreigners owning directly property on border areas and along the coast of the country. However, there are some mechanisms and exceptions for a person or a Mexican incorporated company with foreign investment to acquire property. Those mechanisms and authorisations depend on the purpose for which the real estate will be used.

Real estate acquisition

Negotiations

Negotiations to buy or sell a property in Mexico are not specifically regulated, but rather attend to the will and good faith of the parties.

It is possible to take the negotiations through real estate agencies who serve as intermediaries between buyer and seller. If this is the case, foreign investors shall verify that agencies and their advisors have a certification issued by the Mexican Association of Real Estate (AMPI), which guarantees reliability and professionalism.

Potential buyers usually execute a purchase offer, which contains the general terms of the transaction, such as information about the property, price, conditions for closing, assumptions, exclusive dealing periods and other

typical clauses. Letters of intention may be in force for a certain period of time during which the prospective buyer must maintain the tender and the seller must accept or reject it. It should be noted, that these pre-contractual documents are widely used, but might be difficult to enforce by the parties.

If the seller accepts the offer, the parties should execute a private purchase agreement, which is a binding document for the all parties to buy and sell the property. The conditions and clauses of the sale agreement may be as broad as the parties' desire but must follow the rules of the civil law in the place where the property is located.

Although the terms of the agreement can be freely agreed by the parties, it is common that at the time of the execution of the private purchase agreement, the buyer pays certain amount to the seller on account of the total price and they must set an approximate date on which both parties will attend the notary public to grant the correspondent public deed.

It is important to mention that it is not mandatory to execute a private purchase agreement, since, the final contract will be the public deed that will be signed before notary public. Nevertheless, this is a common practice that allows the parties to have certainty of the deal while the notary public obtain certain documents issued by several authorities with different times of response.

Since gathering these documents may take between 2 to 4 weeks, a private purchase agreement may help the parties to prevent buyer or seller withdrawing from the purchase. Therefore, it is recommended to have a private purchase agreement binding the parties until the public deed is signed.

During the negotiation process, and certainly before executing a binding document, it is recommendable to perform a preliminary investigation of the title property at the Public Registry of Property of the place where the property is located. This research is reliable and brings legal certainty about whether the property has any encumbrance or restriction.

Additionally, if the property will be used by the buyer for business purposes, it is extremely important to verify the development program or "bando" of the state or municipality where the property is located. Development program or "bando" regulates the licenses and authorisations that can be granted according to the works/business to be carried out and the buildings that can be constructed in each land according to "land use" that have been appointed by the authorities.

Public deed

To formalise the acquisition of real property through a sale (which is the most common scheme for transferring property), a notary public is always needed. The notary public is usually chosen by the buyer and, as a skilled lawyer in this matter, the notary will make the legal analysis of the business and will ask the actual owner to exhibit certain documents in connection with the property. The most frequent documents a notary should ask for are: (i) property title (ie, public deed through which the current owner acquired the property); (ii) property tax ballot and any other documents regarding local taxes; (iii) the marital status of the seller.

The public deed is signed by the parties which, in general, are the buyer and seller, unless there is another act that must be formalised simultaneously where another party may appear. For example, when the seller is obtaining a bank mortgage to carry out the purchase, the financial institution must appear as a third party.

In the content of the public deed, the notary relates all documents requested to the seller, the documents requested to the authorities and the personal information of the parties. It is a duty of the notary to make sure the property does not have any charge or encumbrance and that the local taxes related to the property are up to date.

The public deed will also contain the clauses by which the property is being transferred. There are several legal forms by which a property transfer can be performed, such as purchase, endowment, judicial allocation, inheritance allocation, transfer of property derived of a fund trust, etc. It is worth mentioning that the seller is responsible for the hidden defects that the property may present. This clause is applicable even in the absence of the specific contractual provision, because it is considered a natural clause in every purchase contract. The seller is liable for latent defects for about one year. The latent or hidden defects are defined as any damage that makes the property unfit for its use.

Likewise, the seller is responsible for the reparation in case of eviction. This means that in case there is a judgment in favour of a third party where it is recognised the better right to own or hold the property than the new owner (buyer) the seller has the obligation to indemnify.

Public Registry of Property

After the public deed is signed by the parties and all the legal and tax requirements are met, the notary will issue a "testimony" (a public deed), which contains the deed that was signed. Please note that the deed needs to be signed on the official paper of the notary, so it remains in his or her custody. In Mexico the document known as

property title, is the “testimony”. The notary may issue as many testimonies as requested by persons with a legal interest in the property or by judicial authorities.

The first “testimony” issued by the public notary shall be registered in the Public Registry of Property corresponding to the place where the property purchased is located. The Public Registry of Property is a local authority and there is a public registry for each state.

Public Registries of Property have internal regulations and are always governed locally. Furthermore, when applying for a service in a public registry, there are fees that must be paid which vary from place to place.

Notary public fees

In some states of Mexico, notary public fees are regulated by a tariff, but there are other states where fees are unregulated and are charged under the notary´s discretion.

Making a brief analysis of the total costs to be covered for the transfer of ownership of a property, it can be said that cost/fees may range from 0.5% to 4% of the commercial value of the property being purchased.

New buildings and construction issues

In Mexico, it is possible to buy property in pre-sale status or under construction. If these properties are destined for residential use or to be promoted as a timeshare scheme, it is important to verify that the pre-contract signed with the builder is duly registered in the Federal Bureau of Consumer Protection.

Also, the builder is obliged to give the buyer a warranty for no less than five years for structural issues, three years for waterproofing, and one year for other elements counted upon the delivery of the property. The warranty will be in force since the property delivery. During the time of the warranty the builder must perform, at no cost to the buyer, any act aimed at repairing the defects or failures shown by the property.

In Mexico, you can also invest in real estate to modify and remodel or build. According to the building planned to construct, it is necessary to obtain permits or licenses granted by local authorities. Although legislation regulating building authorisations and licenses is local, in most cases there are the following generic types:

Construction license or “manifestation”

It must be requested by the owner of the property and is necessary for starting a construction in a land where there is no construction yet. This license is issued by the local authority in charge of urban development issues in accordance with the Urban Development Program or "bando" of each state or municipality.

When a property is considered as part of the Federal, Historic, Artistic and Archaeological Patrimony, or as part of a conservation area of a state, a technical analysis should be granted by the Ministry of Urban Development, the National Institute of Fine Arts and National Institute of Anthropology and History in order to construct or remodel such property.

Special construction licenses

The special building permit or license is a document issued by the Mexican authority before expanding, altering, repairing, demolishing or dismantling a building or installation.

There are several specific licenses according to the size and use of the building to be constructed. It is advisable to verify the applicable legislation of the state where the land or building is located on a case-by-case basis.

In order to request the abovementioned licenses from the Mexican authorities, there may be other requirements that need to be previously fulfilled such as obtaining the official number and alignment of the property.

Acquisition vehicles

In Mexico, there are several alternatives when investing in the business of construction without spending a great part of a company’s capital. Two of those schemes are briefly described below.

Trust

A trust is regulated in Mexico as a contract where there are three parties: a grantor/trustor; a trustee; and a fiduciary.

There are many types of trusts focusing on building investment.

If an investor is willing to buy land on which the development of apartments or office buildings is planned as a condominium, the investor can negotiate with the current owner of the property to execute a trust where the owner would be one of the trustees as well as the investor. In that case, there will be two kinds of trustees: A and B.

The investor (trustee A) and the seller (trustee B) can agree that by the end of the building process, the investor will pay the price of the property with a private unit such as an apartment or an office. For this transaction, the seller and the investor will execute a trust with the fiduciary (that must be a financial institution authorised for this purpose).

Under this scenario, the investor can dispose of the land to develop the building without spending an initial amount for purchase of the property and instead spend directly on the building works.

In the trust, it is agreed that trustee B will acquire a private unit and trustee A will acquire the profits of the purchases of each private unit. In the end, when every unit, apartment or office is sold, the trust will be extinct.

Some facts worth considering under this juridical figure are: (i) the purchase of each private unit must be done by a public deed of transfer of property derived from the purposes of the trust; and (ii) the investor will have to pay for the fiduciary fees. Also, if properly implemented, no federal and local taxes may arise from setting up the trust and transferring the assets into the trust.

Mortgage "bridge" loan or "*crédito puente*"

This mortgage loan, commonly known as "*crédito puente*" is an interesting mechanism to consider when investing in a building business.

Under this figure, an investor can request a loan from a financial institution in order to buy the land or property where the intention is to develop a building business. Also, this loan will be destined to finance the construction. The investor will guarantee the loan with a property mortgage.

After the construction of the buildings is over, or during the process, the investor will constitute the condominium of the building and agree with the Bank to divide the mortgage in order that each private unit responds for a part of the loan.

Therefore, when each private unit purchase is executed, a part of the paid price will be destined to pay for the loan, and the mortgage regards that private unit will be cancelled. This way, when the total of the private units is sold, the initial mortgage will be paid and cancelled.

Real estate investment trusts (REITs)

In Mexico, since the amendments of the Singular Circular for Issuers (*Circular Única de Emisoras*) were published on the Official Gazette in 2009, a new form of investment trust emerged to create opportunities for those investors who attempt to develop attractive projects in different industries, such as infrastructure, real state, private equity, etc.

Hence, a new form of investment was born in the Mexican market, allowing small or medium companies to have unusual investors such as Mexican pension funds (*administradoras de fondos para el retiro*, or AFORES), whose own legislation allows to invest in negotiable structure instruments issued by an investment trust and listed on Mexican Stock Exchange markets (known as *Bolsa Mexicana de Valores*, or "BMV" and *Bolsa Institucional de Valores*, or "BIVA"). This kind of investment trust may incorporate some characteristics of corporate governance and have to fulfil specific regulations established by National Banking and Securities Commission (CNBV), BMV and BIVA. Furthermore, this investment trust might include an investment plan for the development of the project and contain stipulations about the functions in charge of the Technical Committee and the Advisory Investment Committee.

In March 2011, Fibra Uno Administración, S.A. de C.V., made a public offer for these kinds of certificates for a total amount of 8,876 million USD. Currently there are approximately 16 regular REITs listed in the Mexican Stock Exchange: Fibra Uno, Fibra Hotel, Fibra Shop, Fibra Danhos, Fibra MacQuarie, Fibra Prologis, Fibra Inn, Fibra Monterrey, Fibra Terra, Fibra HD, Fibra Plus, Fibra Educa, Fibra Up, Fibra Nova, Fibra Sites and Fibra Storage.

Additionally, in October 2016, a new tax beneficial regime for REITs was incorporated to invest in energy and infrastructure projects, commonly known as "Fibra-E". Since its incorporation in the Mexican tax framework, the Fibra-E regime has resulted in an attractive mechanism between the investors. Currently, there are four Fibra-E listed in the Mexican Stock Exchange market.

Taxation of Mexican real estate investments

Income tax

Rental income

Mexican taxpayers are subject to corporate income tax on their worldwide income at a 30% statutory tax rate.

In general, taxable income is determined on an accrual basis. Any income related to the rental of real property should be accrued as part of the company's, branch's or REIT's taxable income.

According to the general rule established in the Mexican Income Tax Law (MITL), when the owner of the real property is a foreign resident, income tax should be paid at a 25% rate applicable to the gross proceeds (rental income), without any deductions. Also, please note that specific provisions according to a tax treaty concluded by Mexico may be applicable.

The tax is paid via withholding when the tenant is a Mexican resident. When both the landlord and the tenant are foreign residents, the landlord should remit the income tax to the Mexican tax authorities within 15 days after receiving the rental payment, besides the above, since 2014 according to the MITL, the income derived from dividends from profits generated as from 1 January 2014, will be subject to an additional 10% WHT. However, if Mexico has a tax treaty with the country involved, the tax rate could be reduced or even a withholding exemption may be achieved.

Payments to related parties located in a preferred tax regime (ie, tax haven) are, in general subject to a punitive 40% WHT rate (not applicable in the case of dividend distributions and interest payments in certain cases).

It is important to consider that Mexico is part of the Multilateral Convention to Implement Tax Treaty Measures to Prevent Based Erosion and Profit Shifting (MLI) together with over 100 jurisdictions around the globe. This MLI agreement would add additional requirements to apply tax treaty benefits in Mexico in respect to tax treaties that Mexico has with other jurisdictions that are part of the same convention to the extent that the ratification, acceptance or approval process is also completed in such other jurisdictions. The MLI is not yet in force in Mexico and it is pending to be approved by the Mexican congress.

Depreciation

The Mexican tax legislation allows the deduction of investments in assets via depreciation, using the straight-line method. The MITL provides the maximum depreciation rates that can be used for tax purposes for each type of asset, activity or industry.

An "asset" subject to tax depreciation is considered to be the investment in tangible goods used by a taxpayer to carry out its business activities and which value is diminished by use and time.

Companies are allowed to depreciate the entire cost of an asset and may elect to start depreciating it either in the year in which the asset starts being used or in the following year. Taxpayers lose the right to claim a depreciation deduction if they do not do so in a given year.

The basis for the depreciation in the case of buildings is the purchase price plus incidental acquisition costs and improvements, and the maximum rate provided by the MITL is 5% per year. Land is not subject to depreciation.

Debt financing

When a real estate investment is financed through debt, several issues should be considered from a Mexican tax perspective, such as thin capitalisation, back-to-back rules, 30% interest tax deduction limitation of the entity's adjusted taxable income, non-deductibility of payments made to a preferred tax regime rule (in certain cases), among others.

Based on the Mexican 2020 tax reform, relevant provisions were enacted meant to incorporate fundamentals of the OECD Base Erosion and Profit Shifting (BEPS) initiative that would be applicable on certain payments made outside Mexico and/or non-Mexican investments.

Re-characterisation

Mexico provides several rules that re-characterise interest payments as dividends according to the type of loan, such as profit participating loans, on-demand loans, back-to-back loans, or non-"arm's length" loans.

For Mexican tax purposes, a back-to-back loan is generally defined as any transaction in which one party provides cash, goods, or services to an intermediary who goes on to provide cash, goods, or services to the original party or a related party of the original party. Furthermore, back-to-back loans include loans that are guaranteed by cash, or other deposits by a related party of the borrower or by the borrower itself. This definition is quite broad, and the rule should be analysed in detail on a case-by-case basis.

Value-added tax (VAT)

Interest paid triggers VAT, which should be paid to the Mexican tax authorities on a self-assessment when interest is paid to a foreign resident. However, when the activities of the taxpayer are not subject to VAT (eg, sale of houses and dwellings), VAT on interest becomes a cost on the hands of the payer that should be deductible for income tax purposes to a certain extent.

For Mexican tax purposes, both the terms of the loan and the interest rate should be established on an "arm's length" basis, if the transaction is carried out between related parties.

Withholding tax (WHT)

Interest income received by foreign entities is subject to taxation in Mexico when funds are used in Mexico or when interest is paid by a Mexican resident or by a non-resident with a permanent establishment in Mexico.

WHT on interest income obtained by a non-Mexican resident can range from 4.9% to 35% depending on the type of debt instrument deriving interest or creditor. Such WHT becomes payable (i) at the time the interest becomes due; or (ii) at the time the interest is actually paid, whichever occurs first. Nevertheless, a reduced income WHT rate may be applicable (eg, 10% to 15%) when interest is paid to a tax treaty country and specific requirements are met (eg, the interest is "arm's length", the Mexican withholding agent receives a tax residency certificate from the foreign entity on an annual basis, etc). As mentioned before, MLI (Multilateral Convention)'s provisions should be taken in consideration to apply tax treaty benefits once it is in force in Mexico.

Interest tax exemptions include loans granted i) by the Mexican Federal Government and Central Bank; ii) by foreign financial entities, for a minimum of three years, that promote exportations; iii) by foreign financial entities to institutions to receive tax-deductible donations in Mexico; and iv) qualifying pension funds.

Deductibility of interest

Interest paid to foreign residents may be deductible for income tax purposes to the extent that the following main requirements are met (non-exhaustive list):

- The interest expense must be strictly indispensable for the business activity of the Mexican entity; therefore, the principal should be invested in the main activity of the Mexican company.
- comply with Mexican WHT obligations;
- file informative tax returns with the Mexican tax authorities no later than 15 February of each year, disclosing information related to the loan;
- file an information return with the annual return, detailing transactions carried out with related parties in the previous taxable year;
- comply with the 3:1 debt-to-equity ratio (ie, thin capitalisation rules) at the end of each year;
- comply with the 30% interest tax deduction limitation rule of the entity's adjusted taxable income (ATI). ATI is calculated similarly to EBITDA.
- Interest payments made to non-Mexican residents related parties or made through a structured agreement would not be deductible for Mexican income tax purposes if; a) such payments are subject to a preferred tax regime, b) are part of a hybrid arrangement or c) are payments indirectly subject to a preferred tax regime. Some exemptions to this rule may apply.
- Interest payments made by a Mexican taxpayer that are deductible by another entity of the group or by the same taxpayer in a foreign jurisdiction would not be deductible for Mexican income tax purposes. This rule should not apply if the income obtained by such Mexican taxpayer is considered as taxable income abroad.
- The transaction should be "arm's length" (the interest rate, the period in which interest and the principal become due, as explained above).
- The loan must not fall into the deemed dividend criteria, as explained above.

- Additional formal administrative requirements for deductions should be met, as listed in the MITL, eg, support the expense with invoices complying with the requirements provided by the Mexican tax provisions.

Inflation adjustment effect

A company's monetary assets and liabilities (including liabilities in Mexican pesos as well as those in foreign currency) are subject to an annual inflation adjustment calculation, which could result in the Mexican taxpayer having an inflationary gain or loss.

Foreign exchange gain/loss

For debt denominated in a non-Mexican currency, the currency fluctuation that generate a gain and/or loss are subject to the same tax treatment as interest and are also accounted for on an accrual basis. Hence, a foreign exchange gain cannot be deferred.

Loss carryforward

Net operating losses (NOLs) may be carried forward for a period of ten years. No carrybacks are allowed.

The MITL does not limit the amount of NOLs that can be used to offset income each year during the ten-year carry forward. The only exception is the NOL derived from the disposition of shares must be applied against gains of the same nature.

NOLs are also adjusted for inflation and cannot be transferred to another entity, even in the case of a merger. In the case of a spin-off, NOLs can be divided between the surviving entity and the spun-off entity in accordance with certain rules.

Dividends and capital reductions

Legally, dividends can only be distributed to the extent the distributing company has sufficient book retained earnings recorded in its financial statements and any financial losses are compensated prior to the distribution.

Dividends paid out from the Previously Taxed Earnings Account (CUFIN) are not subject to any further corporate income tax. CUFIN represents the company's after-tax retained earnings that can be distributed to the stockholders as a dividend payment. Dividends not distributed from the CUFIN account are subject to an additional corporate income tax at an effective rate of approximately 42.86%. This additional corporate tax can be credited against the income tax of the year of the distribution and the following two years.

Furthermore, in 2014 the MITL introduced an additional 10% withholding tax on dividend payments to foreign residents (entities and individuals) and local individuals. This WHT does not apply to distributions of profits subject to corporate-level tax prior to 2014 if certain requirements are met. The WHT under domestic law can be reduced or eliminated by applying the benefits of a Double Tax Treaty in force to the extent certain requirements are met.

Regarding capital reductions, the Capital Contribution Account (CUCA) records the capital contributions effectively made by the shareholders. CUCA is used to determine the taxability of capital stock redemptions and liquidations. In general, terms, if the reimbursement of the share upon liquidation or capital redemption comes from CUCA or CUFIN balances, no corporate income taxation is due as a consequence of the capital reduction. Otherwise, corporate income tax at an effective rate of approximately 42.86% should be applicable like a distribution of retained earnings. It is important to mention that the arithmetical calculation to determine whether a capital reduction triggers corporate income tax in Mexico is quite complex and a specific analysis is required on a case-by-case basis.

Value-added tax (VAT)

According to the VAT Law, VAT is payable on the following activities:

- alienation of goods;
- rendering of independent services;
- rentals; and
- import of goods and services.

The general VAT rate is 16%. No special rates apply on the transfer of real property. The sale of land and residential construction are exempt from VAT.

The sale of commercial buildings is subject to VAT at the general 16% rate. Therefore, the value of the building plus all amounts additionally charged to, or collected from, the acquirer, such as other taxes, fees, normal or penalty interest, conventional penalties or any other item will be subject to VAT.

The rental of residential property such as houses or dwellings (except hotels, boarding houses) is not subject to VAT.

The rental of commercial property is subject to VAT. In this last case, the amount charged for the rent will be the tax basis to determine the VAT.

VAT is a “cash basis” tax, with few exceptions (eg, VAT derived from certain interest must be paid on an accrued basis), that is only the receipt of payment for goods or services triggers the output VAT liability, and an input VAT credit may be claimed when the taxpayer pays VAT to its providers of goods and services.

VAT paid on the acquisition or rental of commercial property (input VAT) should be recoverable for the party paying such tax. In order for input VAT to be creditable, the payment to which it relates should be deductible for income tax purposes and the VAT should be clearly stated in the corresponding invoice. If an entity carries out VAT-able and exempt activities, input VAT can only be credited in the proportion of the VAT that corresponds to those taxable activities, so specific allocation should be carried out.

VAT returns must be filed on a monthly basis. All monthly VAT payments are final. The return must be filed by the 17th day following the end of the month. VAT payments must be made together when filing the monthly return.

VAT favourable balances may be credited against future VAT liabilities, or they may be used to offset the tax liabilities arising from other federal taxes. In addition, the taxpayer is able to request the refund of a favourable VAT balance.

Municipal taxes

Real estate transfer tax

This tax is imposed to the purchaser of the real estate. The basis is the appraised value (performed by an official valuator or a cadastre) or market value (transaction or registered price) of the property, whichever is higher.

The tax rate depends on the legislation of the state where the real property is located. In general, the rates imposed by the states range between 1% and 5%. The tax rate in Mexico City may be as high as 5%.

The Public Notary is responsible for remitting the tax. The Notary collects the tax from the acquirer at the moment the public deed for the acquisition is signed and must remit it to the corresponding authorities together with the tax return in the term provided by the local legislation.

Real estate property tax

Real estate property tax is a local tax. The mechanism used to determine it varies, depending on the state and the municipality in which real estate is located. The owner of the real property is liable to pay this tax.

The real estate property tax is based on the official assessed value or the appraised value of real estate.

The tax rate depends on the legislation of the state where the real property is located. In most states, the tax rates are below 1%. However, the effective tax rate may be higher, as the total tax paid is comprised of the tax rate plus a fixed quota. In general terms, this tax is payable bimonthly.

Disposal of property

Mexican taxpayers are taxed on the profit arising from the disposal of real property, which includes both land and building.

For income tax purposes, the capital gain is calculated by subtracting from the sales price, the tax basis of the real property. The tax basis is equal to the acquisition amount, plus improvements, minus accumulated depreciation. The balance should be adjusted for inflation.

The gain will be accrued as part of the company’s taxable income and subject to tax at the general 30% rate.

When the seller is a non-Mexican resident, the MITL provides a 25% tax rate on the gross proceeds of the sale, without any deduction. The tax is paid via withholding when the acquirer is a Mexican resident. When both the seller and the acquirer are foreign residents, the seller should remit the income tax to the Mexican tax authorities.

Alternatively, the MITL provides that if the seller appoints a legal representative in Mexico and complies with other formalities, the sale may be taxed by applying the general 30% tax rate to the net gain arising from the transaction.

Such a legal representative is responsible to remit the income tax to the Mexican tax authorities. There is no need to appoint a Mexican legal representative if the transaction is registered in a public deed.

It is important to mention that the MITL establishes that income tax should be paid on the hands of the acquirer when the commercial value exceeds by more than 10 % the sales price of the property. In these cases, income tax is calculated by applying a 25% tax rate (in case of foreign residents) to the difference between the commercial value and the sales price.

VAT and municipal taxes considerations need to be taken into account upon the disposal of property, as described below.

Notary fees, local taxes, such as the real estate property tax, and other government fees need to be taken into consideration upon the disposal of property. In this regard, government fees are contributions to be paid for a service provided by an authority. In this case, the fees to which we refer are those derived from Public Registry of Property for services regarding the issue of the encumbrance or non-encumbrance certificate requested by the notary public and the registration of the first “testimony” according to the act or acts within it. In Mexico City, the notary public also requests to the Ministry of Urban Development a use of land certificate for the property that is being transferred, for which a government fee should also be paid.

Purchase of a real estate company (disposal of shares)

Transfer of shares carried out by a non-Mexican resident, is subject to taxation in Mexico when such shares are issued by a Mexican company or when 50% or more of the book value of the shares derives directly or indirectly from immovable property located in Mexico.

For these purposes, the MITL provides two options to pay the corresponding income tax:

- apply a 25% rate on the gross proceeds; or
- apply a 30% rate on the net gain arising from the alienation. The net gain will be the difference between the sales price of the shares and their tax basis. To apply this option other formal requirements must be met (eg, not being resident in a preferred tax regime, appointing legal representative in Mexico, and carrying out a specific statutory report issued by a chartered public accountant, etc).

In case the acquirer of the shares is a Mexican resident, the tax should be paid through withholding. If both, the seller and the acquirer, are foreign residents, the seller should remit the income tax to the Mexican tax authorities. In case the seller resides in a non-tax haven country and appoints a legal representative in Mexico for the transaction, such legal representative is responsible to remit the income tax to the Mexican tax authorities. In these two cases, the tax must be paid, and the tax return filed, within 15 days following the alienation of the shares.

Capital losses incurred by non-residents selling shares in a Mexican corporation are not deductible in Mexico.

Share disposal is not subject to Mexican VAT.

Real estate investment trusts (REITs)

Under the MITL, the purpose of a Mexican REIT is the acquisition or construction of immovable property to be used in leasing activities. The immovable property must be held for at least four years. After such period of time the immovable property may be sold.

Upon contribution of the property, the REIT should issue the corresponding equity certificates. Investors contributing immovable property to the REIT are allowed to defer the payment of income tax on the gain from alienating such property. The tax is deferred until the date the investor sells the equity certificates, or the REIT sells the immovable property.

A REIT is required to invest at least 70% of its funds in the acquisition, leasing or sale of real estate; the remaining funds must be invested in registered government securities or in shares of certain investment entities.

The MITL grants REITs the benefit of not having to file income tax monthly advance payments. Instead, at the end of the tax year, the REIT calculates and pays the income tax related to its activities.

In order to obtain certain tax benefits available for REITs, the trust certificates must be publicly traded. Due to the 2020 tax reform in Mexico, income tax benefits for private REITs are no longer available and some rules have been included to regulate the taxation of deferred gains in the context of private REITs. The fiduciary shall distribute at least once a year, at the latest on the 15th of March, at least 95% of the tax result of the previous tax year between the equity certificates holders.

Tax treatment of the Fibra-E

As mentioned, the REIT-E tax regime was introduced in 2016 through Mexican Miscellaneous Tax Rules (MTR) to promote investment in infrastructure and energy projects by granting to the REIT-E vehicles, substantially, the same benefits already provided by the MITL to regular REITs.

In this regard, Fibra-E would be relieved from filing advance income tax payments and would be relieved from taxation in regards of the alienation of Fibra-E certificates, to the extent they are traded in a recognised stock market.

However, as described in prior sections unlike a REIT which must maintain its assets directly, the Fibra-E instead holds qualifying Mexican entities that own and operate the assets. Note that the qualifying Mexican tax resident entities in which the Fibra-E participates would also be relieved from filing monthly income tax returns.

The trustee of the Fibra-E would have to determine the taxable income and withhold income tax that would be attributable to each holder, taking into consideration the deduction of deferred expenses resulting from the energy and infrastructure business activities or from the Fibra-E's operating expenses.

In addition to the above, no alienation would deem to exist for the contribution of assets by a Mexican tax resident entity to a qualifying Mexican tax resident entity if the following requirements are met:

- In a term no longer than six months after the contribution of the assets, a Fibra-E acquires at least 2% of the shares of the Mexican resident qualifying entity from the party which contributed such assets to the other Mexican tax resident qualifying entity.
- The consideration received by the Mexican tax resident legal entity contributing the assets consists strictly of shares of the qualifying Mexican tax resident legal entity for the total value of the assets received.
- The Mexican qualifying entity receiving the assets in fact fulfils all the conditions and limitations included in the MTR.

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2020

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All information used in this content, unless otherwise stated, is up to date as of 30 September 2020.

Real Estate Tax Summary

General

Non-residents may invest in New Zealand property directly or through a local company, non-resident company, trust or partnership.

Investments in New Zealand real property by non-residents may require government approval. The Overseas Investment Office assesses applications for consent from foreigners who intend to make:

- substantial investments (ie, more than 100 million New Zealand dollars, or NZD, although higher specified thresholds apply for Australian investors and investors from member countries of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership); or
- investments in sensitive land (as defined in Schedule 1 of the Overseas Investment Act 2005 and including for eg, residential land, coastal land, farmland, seabeds or areas adjacent to reserves or water).

As part of an application to the Overseas Investment Office to receive consent to invest in sensitive land, among other things, the investor must identify the benefit that the proposed investment brings to New Zealand, or the foreign person must intend to reside in New Zealand indefinitely (or commit to residing in New Zealand under a specific test in the case of residential property). There are different consent requirements for different types of land. (For more information, refer to www.linz.govt.nz/overseas-investment.)

In response to the COVID-19 pandemic, the overseas investment regime was amended to introduce a temporary emergency notification requirement for foreigners to notify the Overseas Investment Office of any transaction not ordinarily screened for consent and which involves the acquisition of 25% or more of a business in New Zealand (regardless of value). This requirement will be reviewed every 90 days and will only remain in place while the COVID-19 pandemic and its associated economic impacts continues to significantly impact New Zealand.

The overseas investment regime is also undergoing further reform which will include enhanced tax disclosures for certain investments by foreign persons. These further changes are expected to come into effect around June 2021.

Separately, offshore persons who buy and sell property in New Zealand are required to provide certain details to their property lawyer or conveyancer, including a New Zealand tax number and their offshore tax identification number. To obtain a New Zealand tax number, a New Zealand bank account is generally required. The driver for this requirement is to make it easier for Inland Revenue to track the buying and selling of property (which may lead to increased New Zealand income tax scrutiny).

Rental income

Net rental income derived from New Zealand real property is taxable in New Zealand. The income tax rates for individuals, whether resident or non-resident, for the 2020-21 tax year, which is generally the year ending on 31 March 2021, are as follows:

Taxable income (in NZD)	Tax rate (in %)
0 to 14,000	10.5
14,001 to 48,000	17.5
48,001 to 70,000	30.0
70,001 or more	33.0

If the owner of the property is a trust, then the tax rate will depend on whether the income is distributed to beneficiaries. If income is retained in the trust, generally the tax rate is a flat 33%.

If the owner of the property is a company, the tax rate is a flat 28%. Unit trusts are taxed as companies rather than trusts.

Rental expenses

Expenditure is generally deductible when it is incurred in deriving assessable income or incurred for the purposes of carrying on a business for deriving assessable income.

The question of when expenditure is 'incurred' has been the subject of extensive case law. The general test which has been developed is that a taxpayer is regarded as having incurred expenditure or loss when the taxpayer is "definitively committed" or "completely subjected" to the outgoing.

Deductible expenditure includes expenditure incurred in deriving rental income such as interest on loans used to acquire property (subject to the New Zealand thin capitalisation rules, the anti-hybrid rules and transfer pricing requirements), routine repairs and maintenance costs, insurance, rates, property management fees and other operating and administration costs.

There are also a number of spreading regimes that can alter the timing of deductions. This includes certain lease related inducements, depreciation, the financial arrangements rules and prepayments, which may apply to spread the deduction over a period to which it relates.

Capital expenditure is generally non-deductible. This is factually dependent, and a large body of case law has developed under the topic of whether expenditure is capital in nature.

The distinction between capital expenditure and revenue expenditure centres on the difference between the structure of a business (capital) and regular conduct of the business (revenue). An expense that intends to produce an enduring benefit for the business is also often regarded as being capital in nature.

However, capital expenditure may be included in the acquisition cost of the property and depreciated in some situations.

Capital gains on the sale of property

There is no comprehensive capital gains tax in New Zealand. However, the definition of income has been expanded to include profits and gains from certain transactions, notably some of those involving the sale of land. Profits on the sale of land are generally taxable in the following situations:

- The land was acquired with a purpose or intention of disposal.
- The taxpayer, or an associate, is (or was at the time of acquisition) in the business of dealing in land, developing or subdividing land, or erecting buildings, and certain other conditions are met.
- The taxpayer, in certain circumstances, has developed or subdivided land or profited from the land being re-zoned.
- Residential land is acquired and sold within five years of acquisition (unless it was acquired between 1 October 2015 and 28 March 2018 where it was subject to a two year holding period post purchase). An exemption is available for property that is used as the main home unless there is a regular pattern of buying and selling land or the exemption has been applied two or more times in the two years before the sale.

Any such gains are generally included in taxable income and taxed at the taxpayer's marginal tax rate. There are limited exemptions to these general rules in restricted circumstances.

Sales of interests in entities deriving their value as to at least 50% from New Zealand real property may also be taxed in limited situations.

Real Estate Investments

Tax depreciation

General rules

The depreciation rate for buildings with an estimated useful life of 50 years or more was reduced to 0% from the 2011-2012 income year until the 2019-20 income year. From the 2020-21 income year, depreciation has been reinstated on commercial buildings at a 2% diminishing value rate (or 1.5% straight-line rate). The depreciation rate for residential buildings remains at 0%.

While the depreciation rate for most buildings is between 0% and 2%, certain components of buildings (such as fixtures and fittings that constitute commercial fit-out (eg, non-load bearing walls or wiring)) are eligible for higher Inland Revenue-determined depreciation rates. The components of a building eligible for a higher depreciation rate are different depending on whether the building is residential or non-residential.

Allocation of purchase price across assets

Parties to a sale and purchase agreement for property must allocate the purchase price to the various classes of assets such as land, building and depreciable property. This allocation is incorporated into the cost base for depreciable property for tax purposes. Allocations are required to be based on market values. Some vendors and purchasers have historically taken different views of the market value that should be allocated to the same assets in a sale and purchase agreement.

A Bill introduced to Parliament in June 2020, if enacted, will require parties to a sale and purchase agreement to allocate the purchase price consistently to each class of asset. If the proposed changes are enacted as introduced, and the parties do not agree an allocation in writing, a vendor will have two months after settlement to perform the allocation and notify the purchaser and the tax authority. If the vendor fails to do this in time, the obligation will shift to the purchaser. Finally, if no allocation is made, the purchaser will be deemed to acquire the property for nil consideration. As a result, the purchaser would be denied depreciation deductions on depreciable property. In the case of revenue account property, no deduction would be available on future disposal for the property's cost.

Sale of depreciable property

If assets that have been depreciated are sold at a value in excess of the depreciated value, the depreciation previously claimed may be recovered, resulting in taxable income in the year of sale (up to original cost). Rental property is deemed to have been sold if the use of the property changes from business to private. The sale is deemed to take place on the first day of the tax year following the change in use.

A taxpayer can claim a tax deduction for a loss made on the disposal of a building in limited circumstances only. These circumstances are where a building has been rendered useless for the purpose of deriving income and has been demolished (or abandoned for later demolition) as a result of this damage. The damage must have been caused by a natural event outside the control of the taxpayer, agent or associate and must not be the result of the taxpayer's failure to act. A tax loss can be claimed on disposal of building fit-out. Such claims must be based on market value of the relevant property.

If the pending law changes mentioned above in relation to purchase price allocation are enacted as introduced, these rules will determine disposal values for the vendor.

Thin capitalisation

Inbound thin capitalisation rules apply to non-resident-owned groups investing in New Zealand. This includes:

- trusts where 50% or more of the settlements are made by non-residents or an associate of the non-resident;
- where a New Zealand company is owned at least 50% by a non-resident (including its associates); and
- where a New Zealand company is controlled by non-residents who are non-associated but who "act together".

Outbound thin capitalisation rules may apply to New Zealand headquartered groups that own foreign equities and are not, themselves, owned by non-residents.

The aim of the legislation is to restrict interest deductibility on excessively geared assets. Interest is effectively non-deductible where an entity's debt percentage (calculated as total group debt/total group assets less non-debt liabilities) exceeds both of the following:

- 60% for "inbound" groups, or 75% for "outbound" groups; and
- 110% of the worldwide group's debt percentage or, 100% where non-resident shareholders are considered to be acting together and other specific circumstances exist.

There are de-minimis provisions giving full or partial relief, which apply (a) to inbound groups that have no related party debt and total interest deductions are less than 2 million NZD, and (b) outbound groups where interest deductions are less than 2 million NZD irrespective of whether the lender is a related party. Other concessions allow the debt percentage to exceed 60% for certain infrastructure projects.

Restricted transfer pricing for inbound related party debt

New Zealand has a restricted transfer pricing (RTP) regime which limits the tax deductions available for interest where inbound related party cross-border debt is at least 10 million NZD, using a prescribed set of rules.

The RTP regime represents a significant departure from OECD principles, and from the traditional transfer pricing approach to related party debt pricing historically accepted by Inland Revenue, which allowed for interest to be priced with reference to the actual loan terms and conditions agreed between parties and general arm's length principles. This can lead to a disconnect between the interest rate that the counterparty jurisdiction will expect based on general arm's length principles.

Anti-hybrid rules

Various jurisdictions around the world, including New Zealand, have introduced anti-hybrid legislation to counteract double deductions and tax mismatches arising from cross border transactions. Where the New Zealand anti-hybrid rules apply, New Zealand tax deductions may be denied, or non-taxable income may be treated as taxable.

Tax losses

Companies in the same group, with 66% commonality of ultimate shareholding, may transfer losses among themselves in certain circumstances, so that losses can be used to offset profits of another company in the same group.

Tax losses incurred by both resident and non-resident taxpayers may be carried forward and used to offset income of any future year. In the case of companies, losses can be carried forward only if there is always at least 49% continuity in the ultimate shareholding from the year in which the losses are incurred to the year in which they are used to offset profits.

The New Zealand Government has announced that it intends to supplement the 49% continuity requirement with a "same or similar business test", which would allow tax losses to be carried forward following a change in shareholding provided an entity carries on substantially the same business as before a shareholding change. Legislation to implement the proposals is expected to be enacted prior to 31 March 2021, with application from the 2020-21 tax year.

It has not historically been possible to carry back tax losses. However, in response to COVID-19, a temporary tax loss carry-back scheme has been introduced to allow businesses that anticipate incurring tax losses in the 2019-20 or 2020-21 tax years to carry those tax losses back to the preceding tax year and access an immediate refund to the extent of the tax effect of the losses. The New Zealand Government has announced its intention to replace the temporary tax loss carry-back scheme with a permanent scheme in due course.

Tax losses arising from residential rental properties (eg, rental losses) are "ring-fenced". Taxpayers may only offset residential rental property tax losses against other residential property-related income (and not against other income such as salary or non-property related business income). Residential rental property tax losses that cannot be offset in the year when they are incurred may be carried forward.

Withholding tax

Interest

Interest with a New Zealand source is taxable to the recipient. The payment of interest to a New Zealand resident recipient will be subject to resident withholding tax (at varying rates depending on the identity of the recipient) unless the lender has obtained an exemption. Registered banks generally have exemptions.

Interest paid to non-residents is subject to withholding tax at the rate of 15%, which is a final tax unless the parties are associated. This rate may be reduced under an applicable tax treaty. New Zealand also has an approved issuer levy regime, under which a 2% levy can be paid instead of withholding tax if the payer and recipient are not associated and other criteria are met.

Dividends

Dividends received by one New Zealand resident company from another are taxable, unless the other company is a wholly owned subsidiary, in which case the dividends are generally tax-exempt. A full imputation system exists in New Zealand, which enables New Zealand resident companies receiving dividends to gross-up dividends with tax credits for taxes paid. New Zealand resident recipients can use these credits to offset any income tax payable.

Dividends paid to non-residents are subject to withholding tax at the rate of 30%. However, this is usually reduced to a maximum of 15% for persons resident in a country with which New Zealand has a double tax treaty. Treaties with certain countries (eg, the US, Australia, Singapore, Hong Kong and Canada) have been renegotiated, and withholding tax rates for dividends paid to recipients in these countries have been reduced further in some circumstances (to 5% or 0%). Dividends that have full imputation credits attached to them are subject to special rules that reduce the withholding tax to 0%.

Residential land sales to offshore persons

A residential land withholding tax (RLWT) applies to sales of New Zealand residential property to offshore persons where the property has been sold within five years of acquisition.

Portfolio investment entity (PIE) regime

New Zealand has an elective portfolio investment entity (PIE) regime which is often used by widely held investment vehicles when they are investing in New Zealand real estate. There are New Zealand tax benefits in holding passive real estate investments through a PIE structure – for example, where a non-resident owns an interest in a PIE:

- Dividends of untaxed earnings are exempt from New Zealand tax;
- Distributions of capital gains arising from the disposal of properties are also exempt from New Zealand tax.

An entity must meet strict criteria to be able to elect to be a PIE. For example, the entity must be widely held, and the underlying investment assets and related gross income must be primarily from passive activity. Other criteria also apply.

Other relevant taxes

Generally, goods and services tax (GST) is levied at a rate of 15%, including in some cases where supplies to non-residents relate to New Zealand land. However, the supply of residential land (including under a residential lease) is exempt from GST.

Most sales of land (and buildings) between GST-registered persons are zero-rated for GST purposes.

No stamp duty or other transaction taxes are levied on the sale of land.

Municipal tax system in New Zealand

Municipal government in New Zealand is made up of territorial authorities (also known as local authorities, city or district councils), regional authorities and community boards. Each of these constituents of municipal government has particular functions.

Local authorities perform services and carry out activities for the benefit of their community. Their responsibilities include providing libraries, parks, parking, civil defence and land use consents. Regional authorities have an environmental focus and their responsibilities include resource management, harbour control, conservation and pest control. Community boards represent the interest of local communities to their local territorial authorities.

Local authority rates

Local authorities in New Zealand have the power to levy tax, known as rates, on land within their boundaries. “General rates” are the principal source of revenue for local authorities in the carrying out of their work in providing services to their local communities.

There is, in effect, a “capital rating system”, where rateable properties are levied on the “rateable value” of the property (as determined by a local authority or council valuation). Basically, all land is rateable. Full or partial exemptions from rates apply in relation to certain land, including Crown land and land used for educational and charitable purposes.

Under the Local Government (Rating) Act 2002 the liability for rates is based on ownership of a “rating unit”. Ownership of a rating unit generally follows the legal ownership, ie, the person registered on the certificate of title will own the rating unit. However, there is an exception for certain types of leases.

The lessee will be the ratepayer in respect of a rating unit where a lease meets the following criteria:

- It is entered into after 8 August 2001.
- It is registered under the Land Transfer Act 1952.
- It is for a term that exceeds ten years.
- It provides for the lessee to be entered as the ratepayer in respect of the rating unit.

Information as to the rateable value and rating unitholder (ratepayer) of all properties is recorded in district valuation rolls and the district ratings’ information database. District valuation rolls are maintained by the various local authorities. Local authorities are required to use the value in the district valuation rolls to levy rates.

Valuations for the purpose of the district valuation rolls can be carried out by approved valuers only. Land and improvements must be revalued every three years, although it can be done at shorter intervals. The occupier or owner of the land may request a valuation at any time but will need to meet the cost of any revaluation they initiate. Land and improvements will also be revalued when changes are made (such as subdivision, erecting a new building, or a change in use of land).

Local authorities must notify the occupier of the result of a revaluation. An occupier can lodge an objection to a revaluation with the local authority, which is then required to refer the objection to an approved valuer (which can be the valuer who revalued the property). Anyone affected by the review can require the objection to be heard by the Land Valuation Tribunal.

Under the Local Government (Rating) Act 2002, rates may be set as general rates or targeted rates. Targeted rates are uncommon but can be used as a way of funding infrastructure.

Regional authority rates

Ratepayers are also liable for regional authority rates. Regional authorities often cover the geographical jurisdiction of several local authorities. Regional authorities use the same methods in determining rates of their local authority members as detailed above.

Resource Management Act 1991

The Resource Management Act 1991 (the RMA) is an important consideration for businesses. The RMA aims to promote the sustainable management of New Zealand’s physical and natural resources.

Resource consents under the RMA are required before undertaking certain activities that might impact on the natural character of the environment or where a use inconsistent with a site's underlying zoning is being sought. Depending on the nature of the consent required, this can be a public process (notified) or non-public process (non-notified). The consent authorities are empowered to impose conditions on the grant of consents. The conditions can range from financial contributions and the undertaking of works to the need to obtain specific permits or submit to certain discharge restrictions. Ongoing conditions can be registered against the title to the land.

The imposition of conditions is a complicated system and details are often embedded in the local authority plans and are specific to the proposed activity. For uses consistent with the underlying zoning, the consenting process is normally straight forward, albeit local authorities do have a certain amount of power over whether they impose conditions.

The RMA is currently under review and a report issued mid-2020 recommends the RMA be repealed and replaced with two new pieces of legislation; the Natural and Built Environment Act (NBEA) and the Strategic Planning Act. The suggested new legislation favours a continued integrated approach for land use planning and environmental protection.

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Real Estate Going Global

Norway

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 12 August 2020.

Real Estate Tax Summary

General

A foreign corporate investor may invest in Norwegian property directly or through a Norwegian limited liability company or Norwegian partnership owning the property.

From a Norwegian corporate tax perspective, it is normally most tax efficient to invest in a special purpose vehicle (SPV) comprised by the tax exemption method (owning the property), as dividends and gains would then be tax exempt at the level of the Norwegian investor. Foreign corporate investors investing in a Norwegian entity covered by the tax exemption method could benefit from the domestic exemption from withholding taxes on dividend distributions (provided that the investor company has sufficient substance and is not resident in a low tax jurisdiction outside the EEA), or rely on treaty protection if applicable.

Rental income

Rental income for a Norwegian corporate investor is subject to the general Norwegian corporate tax rate of 22% (as of income year 2020).

Interest deductibility

As a starting point, interest on debt is tax deductible in Norway. Under the Norwegian interest limitation rules however tax deductibility of a company's net interest expense is limited to 25% of the taxpayers' tax EBITDA, if the taxpayer is a part of a consolidated group for accounting purposes or would have been had IFRS been applied.

Interest arising on intra-group debt are subject to both the interest deduction limitation rules and "arm's length" provisions. For example, thin capitalisation issues could limit the tax deductibility of interest on intra-group debt. The decisive test is whether the group company would have been able to obtain the same conditions from an external party (bank, financial institution, etc).

Under the current tax legislation, interest payments are not subject to withholding tax.

Tax exemption method

Capital gains on shares owned by a Norwegian limited liability company, which is comprised by the tax exemption method, are 100% tax exempt.

Furthermore, dividend distributions from a Norwegian subsidiary where the Norwegian parent company owns and controls more than 90% of the shares and voting rights, are also 100% tax free. The same applies to dividends from foreign subsidiaries within the EEA if the subsidiary is genuinely established and carries out genuine economic activity there (substance requirements based on the ECJ ruling in the Cadbury-Schweppes case).

Dividend distributions to a Norwegian parent company that do not meet the conditions mentioned above, will be subject to 22% tax on 3% of the dividends (effective tax rate of 0.66%).

Depreciation

The acquisition cost of land and sites is not depreciable for tax purposes.

Buildings/assets used for business purposes will normally be depreciable in accordance with the declining balance method. The buildings/assets are allocated to different depreciation groups based on type of asset (ie, office buildings, other buildings and technical installations), and may be depreciated annually at the maximum rate for the group in question.

Real Estate Legal Summary

General

Under Norwegian law, the ownership right is principally absolute. However, this principal is modified both from a private and public perspective.

The Rent Act is non-mandatory within the business sector. If no exception is agreed, the Rent Act will apply.

Standard agreements (SPA) drawn up by the real estate industry is commonly used.

If the property is purchased through transfer of shares, it is recommended to carry out a due diligence.

Real Estate Investments

General

According to the Real Estate Concession Act of 31 May 1974, the acquisition of real estate, including companies owning real estate, may require a concession.

If the foreign investor investing in Norwegian real estate or in partnerships owning Norwegian real estate is not a limited liability company, a statement from the Ministry of Finance may be required to determine who the taxpayer is, either the investment vehicle or its investors for Norwegian tax purposes. This is mainly required from a practical perspective in order to determine whether there are one or 100,000 tax returns that have to be filed.

Due to the tax exemption method, sellers of real estate will prefer to sell shares in the real estate owning limited liability company or ownership interest in the real estate owning partnership.

Tax rate

The Norwegian general corporate income tax rate for both resident and non-resident real estate investors is 22% as of 2020.

Rental income

Rental income and other kinds of earnings derived from real estate in Norway are taxable in Norway, regardless of whether the owner resides in Norway or not.

Deduction of costs

All costs related to operation and administration of the property, including depreciation, are deductible. As a starting point, this also includes interest on loans obtained to acquire, maintain or improve the property. For further details, , please see section "*Interest deductibility*" below.

Timing of income/gain and costs/losses

The main rule for timing of income/gains and costs/losses for tax purposes is the realisation principle.

For income/gains, the realisation principle implies that income/gains must be entered as income in the income year in which the taxpayer obtains an unconditional right to the consideration. As a result, the time of payment is without consequence.

For costs/losses, the realisation principle implies that costs/losses are deductible in the income year in which the taxpayer incurs an unconditional obligation to pay the consideration. As a result, the time of payment is without consequence.

Further on depreciation

The acquisition cost of land and sites is not depreciable for tax purposes but must be capitalised. The same applies for buildings used for dwellings/housing (certain limited exemptions may apply).

Other buildings used for business purposes are depreciable in accordance with the declining balance method. These assets are divided into two depreciation groups:

- (Group h) buildings (other than office buildings), plants, hotels, rooming houses, restaurants, etc, which may be depreciated annually at the maximum rate of 4%. Buildings with such simple construction that, from the date of its erection are assumed to have a useful life of no more than 20 years may be depreciated according to the declining balance method with the maximum rate of 10% annually.
- (Group i) office buildings may be depreciated annually at the maximum rate of 2%.

In addition:

- (Group j) unmovable equipment that serves the use of the building (eg, as elevators, cooling plant) may be depreciated annually at the maximum rate of 10%.

The assets are depreciable at the maximum rate, as of the year of acquisition, on a declining balance basis.

Maintenance and improvement costs

Maintenance costs are tax deductible in the year of accrual. Costs of improvement or extensions of the building in later years must be capitalised and depreciated together with the cost of the building.

Tax consolidation

Norwegian tax law is based on the principle that each company is a separate taxpayer, irrespective of whether it belongs to a Norwegian or international group. However, Norwegian tax law allows for tax consolidation/group relief by way of group contributions.

A group contribution is a gratuitous and unilateral transfer of value from one taxpayer to another within the same group. In short, the group contributions allow a group company to offset its profits against tax losses in another group company. Group contributions have many similarities with dividends; however, one of the major differences is that group contributions in addition to being rendered to the direct parent/shareholder, also may be rendered to an indirect shareholder, subsidiary or a sister company.

There are three main conditions for rendering group contributions with tax effect:

- Both the rendering and the receiving company must be Norwegian limited liability companies (or certain other types of companies mentioned in the Norwegian Tax Act). If certain conditions are fulfilled, group contributions may be rendered to/from a Norwegian permanent establishment (PE) of a foreign limited liability company tax resident in a state within the EEA area[1]. Provided the conditions are fulfilled, Group contributions may also be rendered between Norwegian PE's of foreign limited liability companies.
- The rendering and receiving taxpayer must be within the same tax group, ie, a common parent (Norwegian or foreign limited liability company) must directly or indirectly own and control more than 90% of the shares and voting rights in both companies. The ownership test is made at 31 December in the income year[2].
- The group contribution must be lawful, eg, be resolved in accordance with Norwegian company laws and be within the dividend distribution capacity of the rendering company (which sometimes requires careful planning upfront to make sure that the rendering company has sufficient dividend distribution capacity to give away its taxable profits as a group contribution).

If the above-mentioned conditions (and certain other minor conditions) are fulfilled, a group contribution is deducted from the rendering taxpayer's taxable income and is regarded as taxable income for the receiving taxpayer. The group contribution may exceed the rendering company's taxable income in the year in question; however, the part of the group contribution, which exceeds the year's taxable income, is not deductible, nor is it taxable for the receiver if the above-mentioned conditions (and certain other minor conditions) are fulfilled.

It should be noted that the Norwegian tax authorities uphold that to the extent the rendering company has taxable income, but does not claim a deduction for the group contribution, in whole or in part, that is within the taxable income of the rendering company, that part of the group contribution is still taxable income for the receiving company.

Group contributions are normally decided at the annual general meeting of the shareholders in the year following the income year. If the companies within the Norwegian group draw up statutory company accounts according to IFRS, careful long-term planning with respect to the group contribution capacity may be necessary.

Tax-effective "debt pushdown" in the case of the acquisition of shares in a limited liability company holding real estate may due to the group contribution regime, be possible (ie, a Norwegian holding company is established, its acquisition of the shares in the real estate company is financed with debt[3] and the real estate company's income[4] is used to offset the holding company's loss).

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1 The EEA area consists of the EU countries and the EFTA countries (Iceland, Lichtenstein and Norway).

2 Or at the last day of the income year if deviating financial years are applicable.

3 In case of shareholder/intra-group loan/guaranteed loan the debt equity ratio, interest rate, etc, depends on what is "arm's length".

4 To the extent, there is distribution capacity.

Local funding alternatives

Debt versus equity

In Norway, financing with debt is often advantageous, because interest costs may be deductible (in the case of share investments, please see section "*Tax consolidation*" above), while dividend distributions are not.

Withholding tax is currently not levied on interest paid from a Norwegian debtor to a foreign creditor under current legislation. However, withholding taxes on dividend payments are as a starting point levied at a rate of 25% under domestic law, but may be reduced under a domestic law exemption or through applicable tax treaties. It should however be noted that the Ministry of Finance released a discussion paper on the proposal to introduce withholding tax on interest and royalties on 27 February 2020. The main purpose of the proposal is to counteract profit shifting from Norway in the form of high deductible interest payments to related recipients abroad counter double non-taxation in cases where the income is tax exempt or subject to a low tax at the hand of the recipient. The proposal only encompasses interest payments to related parties resident in "low tax" jurisdictions. The proposed withholding tax rate on such payments is 15% of gross amount. The Ministry proposes that the rules shall enter into force with effect from 1 January 2021.

Even though withholding tax on interest seems likely to be introduced, it may be postponed due to the COVID-19 pandemic.

If using a Norwegian limited liability company to acquire the real estate directly or indirectly through shares in a real estate owning company, the decision with respect to the funding (equity vs debt) should also consider Norwegian company law restrictions, inter alia, the dividend distribution or capital reduction capacity, the very strict lending prohibitions and financial assistance prohibition regarding intra-group loans.

Any guarantees or security provided by acquired companies in Norway to a BidCo's lender in relation to the acquisition would be considered as financial assistance under Norwegian corporate law. To be allowed, such financial assistance needs to meet certain conditions, but would normally also result in a reduction of the distribution capacity/free reserves.

However, please note that there are some exceptions available for pure real estate holding companies. There is also a current proposal on public consultation, which is expected to result in a certain loosening of the general restrictions.

Further on interest deduction

The tax deductibility of interest is not dependent on the purpose of the debt, provided the debt cannot be characterised as equity.

As a starting point, interest on debt is deductible for tax purposes in Norway. In 2013, interest limitation rules where implemented, limiting tax deduction for interest payments to related parties. Since implementation the Norwegian interest limitation rules has been amended several times and the scope of the rules significantly increased.

Under the current rules, there is a distinction between Norwegian companies that are considered part of a group and companies that are not. The requirement to be classified as a Norwegian company within a group is that the financials of the Norwegian company is included in a consolidated financial statement or would have been had IFRS been applied.

For Norwegian companies that are part of a consolidated group there is no distinction between third party interest costs or related party interest costs, tax deductions are limited to 25% of net interest expense of the Norwegian company's' tax EBITDA. This is the ordinary taxable income of the company after certain adjustments.
The restriction on interest expense is calculated separately for each separate taxpayer.

In short, the tax EBITDA is a computation of:

Taxable income
+/- Group contributions
- Use of tax losses carried forward
+/- Net interest expense
+/- Tax depreciation
= Tax EBITDA

Any increased taxable income arising from the interest limitation rules cannot be offset by any brought forward tax losses or by group contributions. Consequently, an adjustment under these rules is likely to result in additional tax payable. However, current year tax losses may be offset against increased income. Disallowed interest expenses can be carried forward for ten years.

The rules do not apply if annual net interest expense for the Norwegian part of the group is below a threshold of 25 million Norwegian kroner (NOK). Further, there is an equity escape clause granting full deductions for interests, provided that the taxpayer is able to demonstrate that the equity ratio in the Norwegian part of the group (or on single Norwegian company basis) is equal to or not more than 2 percentage points lower than in the group as a whole.

The escape provisions are based on the equity ratio of the entire group as an equal ratio would support the fact that no profit shifting has taken place by way of allocating an unproportionate amount of debt in Norway. Consequently, pure Norwegian groups would always qualify for the exemption and be able to deduct all interest as the comparison between the Norwegian group and the entire group would be a comparison of the exact same figures.

There are quite substantial documentation requirements for taxpayers wishing to apply the equity escape clause. For example, a debt may be at nominal value in the local accounts and fair market value in the group accounts. In addition, goodwill (or badwill) and other (positive or negative) excess values in the group accounts, relating to the Norwegian company or the Norwegian part of the company group, must be allocated to these entities.

In case different accounting principles have been applied in the local Norwegian accounts and group accounts, the local accounts must be adjusted in line with the principles applied in the group accounts. The comparison can be made with group accounts prepared under Norwegian GAAP (NGAAP), IFRS, IFRS for SMEs, local GAAP of an EEA country, US GAAP or Japanese GAAP. If no such group accounts exists, group accounts under IFRS has to be prepared in order to apply the equity escape-clause. The group accounts and the local accounts for the Norwegian company, or alternatively, the local accounts of the Norwegian part of the group, including the above-mentioned adjustments, must be approved by the auditor.

In addition to the above, any interest cost to a related party not comprised by the group (eg, individual holding 50% of the shares/interest in the Norwegian taxpayer directly or indirectly) is not covered by the above mentioned equity escape clause and is limited to 25% of the Norwegian company's tax EBITDA. Bank debt that is backed with a related party guarantee may be reclassified as internal debt and the interest cost deduction may be disallowed. The security package for bank facilities, etc, should, therefore, be structured carefully in order to mitigate risk of reclassifying external debt to internal debt. The threshold for application of this rule is net interest cost exceeding 5 million NOK at the level of the Norwegian taxpayer.

The "arm's length" principle

Please note that the interest limitation rules and the "arm's length" principle operate alongside one another. If for example internal interest partially or fully is disallowed under the "arm's length" principle, it is the reassessed amount of interest that is the basis for applying the interest limitation rules.

Under the "arm's length" principle, the deductibility of interest on related party loans is subject to the debt being accepted as such for tax purposes. For the interest cost to be deemed tax deductible, the test is whether the company would have been able to borrow the same amount of debt on the same conditions from unrelated parties. Further, the rate of interest must be "arm's length". The question of, for instance, thin capitalisation normally arises with respect to shareholder loans/intra-group debt (and/or shareholders/intra-group guarantees or similar arrangements for unrelated party debt). It is important to be able to substantiate and document that gearing levels resulting from any shareholder loans, etc, are at "arm's length". The same also applies to the other terms of the loans, such as applicable interest rate.

The general Norwegian Tax Act does not have any specific thin capitalisation rules, but the "arm's length" principle is applied, and it requires that the company not be thinly capitalised. As there are no specific statutory regulations, a generally acceptable debt-to-equity ratio has not been set. The main issue for Norwegian tax purposes is what debt-to-equity ratio an independent lender would accept under the same circumstances. This assessment must be made on a case-by-case basis, where all relevant factors are taken into account (eg, current and expected cash flow, type of business, contract situation, level of interest-bearing debt, interest coverage, security etc).

In practice, the basic effect of a shareholders/intra-group loan (and/or shareholders/intra-group guarantees or similar arrangements for unrelated party loan) not fulfilling the "arm's length" requirement is:

- Non-deductibility of the part of the interest that is related to debt that could not have been obtained by the company on commercially acceptable terms on a "stand-alone" basis.
- No deductibility/income for the company for the same part of currency losses/gains.
- Non-deductible interest payments may also be treated as deemed dividend and dividend taxation of the company's shareholders may be carried out on that basis (ie, the dividend distributions may be seen as unlawful and thus not comprised by the tax exemption method for corporate investors).

If real estate is acquired directly by a foreign taxpayer, it is recommended that any loans are established at the point in time of the acquisition of the real estate and with the real estate as mortgage. Later refinancing, ie, increase of loans or insertion of loans may be difficult.

Exchange gains and losses

Exchange gains/losses on debts are normally taxable/deductible. With respect to gains on long-term loans, using a "revaluation account" for tax purposes implies that the year's net unrealised exchange loss is deductible while net unrealised gains will only have to be entered as income to the extent that there is an uncovered loss in the "revaluation account".

Capital gains and losses on the sale of property

Capital gains/losses on the sale of real property owned by both resident and non-resident taxpayers are taxable/deductible.

Normally, gains on sale of real estate, other depreciable property and non-depreciable property that is used for business purposes, may be transferred to a collective "gains and loss account" to the extent the gains are not treated as income in the year of the sale. On a declining balance basis, at least 20% of such positive "gains and loss account" must be entered as income annually. As a result, it is effectively possible to achieve a partial deferral of income recognition for tax purposes. It is mandatory to transfer losses to the "gains and loss account", which is charged with a maximum of 20% annually on a declining balance basis.

Capital gains and losses on the sale of shares in limited liability companies and ownership interest in partnerships

Norwegian tax resident limited liability companies' gains on shares in Norwegian limited liability companies and similar Norwegian entities (and certain foreign limited liability companies/similar entities) are tax exempt under the Norwegian tax exemption method. To the extent, a gain on shares in a Norwegian limited liability company is not taxable; losses on the shares are not deductible either.

Non-resident taxpayers' gains on shares in Norwegian tax resident limited liability companies and similar Norwegian entities are not taxable in Norway. If the shares are effectively connected to a Norwegian PE, gains will tax exempt and losses will be non-deductible to the extent the foreign company is comprised by the tax exemption method (ie, if the foreign company corresponds to a Norwegian limited liability company).

Norwegian or similar entities' (including certain foreign limited liability companies) capital gains on ownership interests in Norwegian partnerships (and equivalent foreign partnerships) are as a main rule, comprised by the tax exemption method.

However, capital gains in connection with realisation of an ownership interest in a Norwegian partnership or equivalent foreign partnerships, are taxable if the partnership's value of shares, etc which are not comprised by the tax exemption method (eg, investments in companies in low tax jurisdictions), at any point in time during the last two years prior to realisation has exceeded 10% of the partnership's total value of shares, etc.

Losses on ownership interests in Norwegian partnerships or equivalent foreign partnerships are only tax deductible if at least 10% of the partnership's investments for two years prior to realisation continuously have comprised shares, etc, not covered by the tax exemption method (eg, shares in companies in low tax jurisdictions).

There are many unresolved questions arising from the exemption from the main rule regarding partnerships. For instance, with respect to a chain of partnerships: if a partnership owns an interest in another partnership, it is uncertain whether any shares owned by this second partnership should be taken into account when determining the total value of shares and the value of shares outside the exemption method for shares.

Direct and indirect costs connected to acquisition and realisation of investments that qualify for the tax exemption are not deductible. However, debt interest and certain other financing expenses in connection with share/partnership acquisitions may potentially be treated as deductible. Transaction costs incurred in a deal process that is discontinued are in any event not deductible.

Limitations on the tax exemption method

Prior to 2012, dividend distributions and capital gains comprised by the tax exemption method suffered an effective tax rate of 0.84% (28% taxation of 3% of the gains/dividends), pursuant to amendments made to the tax exemption method in 2008.

However, as per 1 January 2012 gains on shares comprised by the tax exemption method are 100% tax exempt.

Furthermore, dividend distributions from a Norwegian subsidiary where the Norwegian parent company owns and controls more than 90% of the shares and voting rights, are also 100% tax free. The same applies to dividends from foreign subsidiaries within the EEA comprised by the tax exemption method if the subsidiary is genuinely established and carries out genuine economic activity there (substance requirements based on the ECJ ruling in the Cadbury-Schweppes case).

Dividend distributions covered by the tax exemption method that do not meet the conditions above, will still be subject to 22% tax on 3% of the dividends (effective tax rate of 0.66%).

Ordinary group contributions or dividends when the subsidiary is owned and controlled with more than 90% are not covered by this rule and will therefore not be affected. If an extraordinary group contribution is given, this will, according to the tax authorities, be taxed as a dividend distribution.

Tax loss carryforward and carryback

As of 1 January 2006, tax losses may be carried forward indefinitely. As of 1 January 2006, also, discontinuance of business activity in which the loss was incurred has no effect of the possibility to carry the loss forward.
The carryforward may be lost or reduced due to debt remission or bankruptcy. Finally, loss carryforwards may be discontinued, due to “look-through”/”substance-over-form” regulations[5].

If the business activity in which the loss was incurred is discontinued or the company is wound up, the losses may be carried back up to two years prior to the year the business ceased/the company was wound up.

Dividends and withholding tax

Lawful dividends distributed from a Norwegian limited liability company to its Norwegian tax resident shareholders, which are also limited liability companies/similar entities, are comprised by the tax exemption method.

Please note that repayment of capital (including premium) and distributions in relation to liquidation are not considered dividends.

Dividends distributed from a Norwegian limited liability company to its non-resident shareholders are as a starting subject to 25% withholding tax. The rate may, however, be reduced under domestic Norwegian tax law or through an applicable tax treaty.

Based on the domestic exemption, lawful dividends paid to foreign limited liability companies (and certain other similar entities) tax-resident within the EEA area are not subject to withholding tax, provided the company is genuinely established and carries out genuine business activity in an EEA state.

Norwegian withholding taxes are currently only levied on dividends. Thus, payment of rent, debt principal, interest, and administration fees, other services fees and proceeds for property to non-residents are not subject to withholding tax in Norway.

“Look-through”/”substance-over-form”/anti-avoidance regulations

The general anti-avoidance rule

A general anti-avoidance regulation has been developed by the Norwegian Supreme Court and the tax authorities over a long period of time. Under the non-statutory anti-avoidance regulation, a transaction (or series of transactions) may be disregarded for tax purpose if the transaction is (i) mainly tax motivated, and (ii) regarded as disloyal to the tax law.

With effect from 1 January 2020, the general anti-avoidance regulation was codified in the Norwegian Tax Act. The enactment of the general anti-avoidance regulation is more or less a codification of existing case law.

However, if the non-statutory anti-avoidance regulation is not applicable to a transaction or series of transactions, the statutory anti-avoidance rule (see below) may still apply.

[5] For instance, if the prevailing motive for acquiring a company with a loss carry forward is to use the loss, the loss may be discontinued due to the “look-through”/”substance-over-form” regulations.

The Norwegian Tax Act 14-90

As a result of the introduction of the exemption method for share gains, a statutory anti-avoidance rule has been introduced. The rule applies to companies (and certain other entities) that have certain tax positions (eg, losses carried forward and positive gains and loss account (ie, a latent tax liability)). If such a company is party to a merger, demerger, or has its ownership altered as a consequence of a merger, demerger or other transaction, and it is likely (ie, more than 50% probability) that the utilisation of such general tax position is the prevailing motive (ie, more than 50% motive) for the transaction, the tax position(s) will be:

- discontinued if it represents a tax advantage (eg, tax loss carryforwards will be discontinued); or
- entered as income without the right to settle against losses if it represents a tax liability (eg, a positive "gains and loss account" may not be used as basis for group contributions to the new owner that has a loss).

However, if the statutory anti-avoidance rule is not applicable to a transaction or series of transactions, the non-statutory "look-through" regulation may still apply.

Stamp duty on the transfer of real estate

A 2.5% stamp duty is payable on the transfer of real property title in Norway. The stamp duty is calculated on the sales value (ie, the market value) of the property. There is no stamp duty on sublease of property, or on the transfer of shares or parts in limited liability companies or partnerships holding real property.

Value-added tax (VAT)

There is no VAT on purchase, sale, sublease, etc of real property in Norway. The owner and sub-lessor of real property may apply for a voluntary VAT registration if the property is leased for use in VAT-liable activity. Such registration may often be advantageous because it opens up for deduction of input VAT on construction, maintenance and improvement costs. The general VAT rate is currently 25%.

Please note that there may be VAT consequences connected to sale of real property, even though the sale as such is exempt from VAT, especially if the seller has deducted input VAT in connection with construction, etc.

Applicable from 1 January 2008, the building of a new building, or the rebuilding or improvement work on an existing building, will create a possible obligation to return a proportional part of the deducted VAT (obligation to adjustment of VAT), provided the property is used more in non-VAT liable activity (compared with the original use), or sold within a period of ten years from the year of completion. A possible obligation to return a proportional part of the deducted VAT will also apply if the owner's right changes in case of merger or demerger.

Provided the owner of the building does not have the right to deduct VAT at the time of building/rebuilding/improvement, due to non-use in activities liable to VAT, there will be created a potential right to deduct a proportional part of the VAT (right to adjustment of VAT) paid at the time of construction. This provides that the building, or part of the building, is taken into use in business liable to VAT, or is leased for use in VAT-liable activity within a voluntary VAT registration within a period of ten years from the year of completion.

This obligation or right to adjustment of VAT may be transferred to the buyer in case the property is sold. In order to transfer an obligation to adjustment of VAT, the parties need to enter into a contract according to the Norwegian VAT regulation section 9-3-3.

The obligation or right to adjustment of VAT occurs only if the VAT cost of the building or construction work exceeds 100,000 NOK (total cost must exceed 500,000 NOK including VAT). A lessee may also hold an obligation or right to adjustment of VAT provided rebuilding or improvement work is paid by them.

One shall only adjust VAT if the change of use of the property exceeds 10% compared to the utilisation at the time of completion of the building/rebuilding/improvement work.

Please note that the Norwegian VAT authorities make stringent demands of documentation concerning building costs and costs in relation to the use of VAT-liable activity in the building.

Other real estate taxes

Norwegian limited liability companies are not subject to capital/wealth tax. Non-resident investors, which are not limited liability companies, owning real property in Norway, may be liable to capital tax (net wealth tax) at a maximum rate of 1.1%. Debt related to the acquisition, maintenance and improvement of the property is deductible when calculating the net taxable wealth. Non-resident limited liability companies and similar entities are

not liable to capital taxation in Norway. Beginning in 2010, the rules regarding valuation of real estate for tax purposes have been changed resulting in a higher tax valuation for some real estate, especially secondary and unused real estate.

Norwegian municipalities may levy a special real estate tax in certain areas. The tax rate usually varies between 0.2% and 0.7%. For instance, the municipality of Oslo has such tax, but this needs to be assessed specifically on a case-by-case basis as the computation and rates vary depending on the location.

Advance, binding rulings

The Norwegian Tax Directorate may issue advance, binding rulings regarding certain questions concerning Norwegian tax law and VAT law. In certain cases, the local tax offices may also issue advance, binding rulings concerning Norwegian tax law. The application for a ruling must be substantiated by a requirement to solve fiscal problems related to a specific and actual matter for the taxpayer. The question must be of an important nature for the taxpayer or of common interest.

Other legal aspects

The right of ownership

Under Norwegian law, the ownership right is defined as the right to possess, use and dispose of land in the most absolute fashion as long as no prohibited use is made thereof (absolute ownership). The right of ownership includes, besides the land itself, the following:

- the space above the land and the subsoils to the extent that it is of interest to the owner; and
- property attached to the soil, such as buildings, the products of the land and all items incorporated in a building during its construction.

In order to secure legal protection of the ownership and title, one must register the deed at the Norwegian Mapping Authority.

Limitation of absolute ownership

The absolute ownership may be limited by private encumbrances.

As a main rule, encumbrances will be registered and appear in the property register. However, the electronic property register may not show all registered encumbrances. In order to get a full overview, one must also check the historical property register and the property register of the declarant property.

Public law regulation may also limit the absolute ownership. The public law regulations are scattered and detailed and may have the following classification as:

- requirements regarding the property and building as such;
- requirements regarding new projects, eg, the erection of a building requires that a building permit is obtained beforehand from the municipal authorities. Further, most projects must be approved by the municipal authorities. The threshold for demanding that the owner applies for an alternation of the existing zoning plan is low. These processes may be both expensive and time-consuming.
- general requirements regarding business; and
- specific requirements for the business conducted in the building.

Rental

Law regulates rental, but the Rent Act is non-mandatory within the business sector. If no exception is agreed, the Rent Act will apply.

The sales agreement

The purchase of real estate is affected through the conclusion of a sales agreement. In Norway, it is common to use a standard agreement that is drawn up by the real estate industry. There are standard agreements, both for sale and rental, and is alternated in each specific case based on the parties' negotiation. If the property is purchased through transfer of shares, it is recommended to carry out a due diligence.

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2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

Normally, foreign investors invest in Philippine real property through a corporation in a joint venture with Filipino individuals or Filipino-owned corporations.

Rental income

Rental income earned by a real estate company is subject to ordinary corporate income tax at the rate of 30% on net taxable income, ie, gross rental income minus deductible expenses. There is a 5% creditable withholding tax (CWT) imposed on the gross rental amount to be withheld by the lessee, which can be used to offset or be credited against the 30% corporate income tax liability of the lessor. In effect, the 5% CWT withheld is an advance payment of income tax, and any CWT which could not be credited against any tax due in a particular tax year, can be carried forward to succeeding years.

Thin capitalisation

The Philippines does not have any statutory thin capitalisation rules, although this may not prevent the Bureau of Internal Revenue (BIR) from pursuing the issue. Revenue Audit Memorandum Order (RAMO) No 1-98 notes that thin capitalisation is a common form of tax avoidance and suggests to examiners that they should determine and apply a reasonable debt-to-equity ratio considering all the factors surrounding the case of the particular taxpayer.

Although the 3:1 debt-to-equity ratio is no longer required by the Board of Investments as of 2018, at a practical level, the BIR generally considers this ratio as a reasonable “safe harbour” debt standard.

Real Estate Investments

Legal aspects

Ownership of real estate

Generally, foreign individuals or corporations cannot privately own land in the Philippines. However, foreign investors can acquire up to 40% of the equity in a domestic company that owns land in the Philippines. Moreover, foreign individuals or companies can own 100% of a condominium unit, although the condominium units owned by foreign investors should not exceed 40% of the total units in a particular condominium project.

Ownership of real properties is normally represented by titles issued in the name of the owner. Registration of title in the Register of Deeds constitutes notice to the world that the property is owned by the person in whose name it is registered. While title may still be established through other means, the burden is against the one claiming ownership who is not the registered owner.

Co-ownership

There is co-ownership whenever the ownership of an undivided thing or right belongs to different persons. The share of the co-owners, in the benefits and charges, shall be proportional to their respective interests. It is presumed that the portions belonging to each co-owner are equal, unless the contrary is proved.

Leasehold

Although foreigners are prohibited by the Constitution from acquiring lands in the Philippines except by hereditary succession, they can lease real property in the Philippines.

If the lease is for investment purposes, the maximum period allowed for the duration of leases of private lands to (a) foreigners or, (b) foreign-owned entities not qualified to acquire private lands is 50 years, renewable once for another 25 years. For other purposes, the maximum period allowed is 25 years, renewable for another 25 years.

Every lease of real estate must be recorded in the Registry of Property for it to be binding upon third persons.

Contracts

Under the Statute of Frauds, the sale of real property or an interest therein must be in writing in order to be enforceable. However, such sale is valid regardless of the form it may have been entered into as long as the requirements of a valid sales contract are present.

To be binding to third parties, the sale must be registered in the Registry of Deeds of the province or city where it is located. The sale must be in a public instrument to be allowed registration.

Lease for a period of more than one year should also be in writing to be enforceable.

Tax aspects

Sale/acquisition and lease of real estate property

Capital gains tax (CGT)

Sale of real property shall be subject to the capital gains tax (CGT) of 6% on the gain presumed to have been realised on the sale, exchange or disposition of lands and/or buildings which are not actually used in the business and are treated as capital assets.

Capital assets are defined as property held by the taxpayer (whether or not connected with his trade or business), but not including the following:

- stock in trade or other property of a kind which would properly be included in the inventory, if on hand at the close of the taxable year;

- property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business;
- property used in trade or business, of a character which is subject to allowance for depreciation; and
- real property used in trade or business of the taxpayer.

Ordinary income tax/expanded withholding tax

Sale of real property classified as ordinary assets, however, shall be subject to ordinary income, and any gain/income from the sale or exchange of such real properties shall be subject to the 30% normal corporate income tax (CIT) or 2% minimum corporate income tax (MCIT), as the case may be.

The gain is the difference between the gross selling price or the fair market value, whichever is higher, and the cost of the land.

The sale shall also be subject to the expanded withholding tax (EWT). The rate of withholding tax normally depends on whether the seller is exempt or taxable, habitually engaged in real estate business or not, and where the seller is habitually engaged in real estate business, on the amount of the gross selling price.

If the real property is sold at less than fair market value, in addition to the income tax liability, the BIR may also assess a donor's tax at the rate of 6% on the supposed gift based on the excess of the fair market value over the selling price, unless the taxpayer can prove that the transaction is bona fide and without any intent to evade tax.

Value-added tax (VAT)

Generally, sale of real properties held primarily for sale to customers or held for lease in the ordinary course of trade or business is subject to 12% VAT. The VAT shall be based on the gross selling price of the real property sold.

The gross selling price of real property for VAT purposes is the higher amount among the following:

- the consideration stated in the sales document;
- the zonal value determined by the Commissioner; or
- the fair market value shown in the schedule of values of the Provincial and City Assessors (real property tax declaration).

The following sales are exempt from VAT if the instrument of sale (whether the instrument is nominated as a deed of absolute sale, deed of conditional sale or otherwise) executed and notarised on or after 1 January 2018:

- sale of residential lot not exceeding 1,919,500 Philippine pesos (PHP); and
- sale of residential house and lot or other residential dwellings not exceeding 3,199,200 PHP.
  - Beginning 1 January 2020, the VAT exemption threshold shall be reduced to 2,000,000 PHP, applicable only to the sale of residential house and lot, or other residential dwellings.
  - VAT may be imposed on incidental sales.

Likewise, the lease of a residential unit with a monthly rental not exceeding 15,000 PHP per month shall be exempt from VAT.

The term "unit" shall mean an apartment unit in the case of apartments, a house in the case of residential houses; per person in the case of dormitories, boarding houses and bed spaces; and per room in case of rooms for rent.

The 12% VAT may be passed on to the buyer. If VAT-registered, the buyer may use the paid VAT as input tax credit against its own VAT obligations to the government.

No VAT, however, shall be imposed on the sale, exchange or transfer of securities forming part of a REIT's real estate-related assets.

Documentary stamp tax (DST)

DST is imposed on the privilege of entering into certain transactions through the execution of specific instruments or documents as follows:

Document	Document stamp tax (DST)
Sale, conveyance and donation of real property	15 PHP for each 1,000 (effectively 1.5%) is levied on the consideration paid for the real property, or its fair market value, whichever is higher

Leases agreements on land and other tenements	6.00 PHP for the first 2,000 + 2.00 PHP for every 1,000 thereafter is levied for each year of the agreement
Mortgages, pledges, and deeds of trust	40.00 PHP for the first 5,000 + 20.00 PHP for every 5,000 thereafter is levied on the amount secured

Investment in a real estate company

Capital gains tax (CGT)

The sale of shares in a real property company not listed on the Philippine Stock Exchange (PSE) by domestic corporations, Filipino citizens, resident foreigners, and non-resident foreigners engaged in trade or business in the Philippines is subject to the flat capital gains tax (CGT) of 15%. On the other hand, the sale of shares by both resident foreign and non-resident foreign corporations is subject to CGT of 5% on the first 100,000 PHP taxable gain, and 10% on any gain in excess of 100,000 PHP. If the shares are listed on and traded through the PSE, then their sale will be subject to the stock transaction tax (STT) of 0.6% on the gross selling price of the shares.

Revenue Regulations 06-2013 (RR 06-13) issued by BIR implements the rule on sale, barter, exchange or other disposition of shares of stock not traded through the Local Stock Exchange. Under the RR, in determining the value of the shares, the Adjusted Net Asset Method shall be used whereby the assets and liabilities are adjusted to fair market values. The net of adjusted asset minus the liability values is the indicated value of the equity.
The appraised value of real property at the time of sale shall be the higher of:

(i) fair market values as determined by the Commissioner;

(ii) the fair market value as shown in the schedule of values fixed by the Provincial and City Assessors; or

(iii) the fair market value as determined by an independent appraiser.

If the seller is a resident of a country with which the Philippines has a tax treaty, then the seller may be exempt from CGT under the capital gains' article of that particular treaty. However, under a majority of Philippine tax treaties, the exemption will not apply if the assets of the issuing company consist principally of real property. Note that certain tax treaties exclude STT, which is an excise tax rather than an income tax, from the scope of coverage.

While case law provides that a tax treaty relief application (TTRA) is not required to avail of treaty benefits, it becomes a practical necessity to secure an approved TTRA ruling from the tax authorities for purposes of securing the Certificate Authorizing Registration (CAR) that will allow the transfer of legal title.

Documentary stamp tax (DST)

The sale of shares in a real estate company, which are not listed and traded through the PSE, is subject to DST at the rate of 1.50 PHP for each 200 PHP, based on the par value of the shares (effectively 0.75%). However, if the shares are listed and traded through the PSE, the sale of said shares is exempt from DST.

Dividends

Dividends received by a resident corporation from a Philippine corporation are not subject to any income or withholding tax. However, if the recipient is a Filipino or resident alien individual, any dividend income derived from a Philippine corporation will be subject to the final withholding tax of 10%. On the other hand, dividends paid by a Philippine corporation to non-resident alien (NRA) individuals not engaged in trade or business in the Philippines are subject to the final dividend withholding tax of 25%, while dividends paid to an NRA engaged in trade or business in the Philippines are subject to withholding tax of 20%. An NRA individual who stays in the Philippines for an aggregate period of more than 180 days during a calendar year is deemed to be a "non-resident alien doing business in the Philippines".

Dividends paid to non-resident foreign corporations are subject to a tax of 30% in general. However, the tax rate applicable to a non-resident foreign corporation may be reduced under the following conditions:

- If the recipient is considered as a resident of a tax treaty country, the applicable tax treaty rate will apply.
- If the non-resident foreign corporation is liable for taxes on such dividend in its country of residence, but the country allows a credit of 15% of the taxes deemed to have been paid in the Philippines against the taxes due in the country of residence, then the non-resident corporation would be liable for only 15% Philippine dividend withholding tax.
- If the country of residence of a non-resident foreign corporation does not impose any tax on such dividends received from a Philippine corporation, then the 15% dividend withholding tax will also apply.

Taxation of a real estate business

Corporate income tax (CIT)

Corporate income is taxed at a rate of 30% on net taxable income, ie, gross rental income minus deductible expenses.

Minimum corporate income tax (MCIT)

A MCIT of 2% of annual gross income is levied on a corporation beginning in the fourth taxable year following the year in which the corporation commenced its business operations. The MCIT will apply if it exceeds the regular corporate income tax payable.

For purposes of applying the MCIT, the term gross income means gross sales less sales returns, discounts and allowances, and cost of goods sold. Cost of goods sold includes all direct costs. The amount of MCIT exceeding the regular corporate income tax payable in a particular year can be carried forward and credited against the regular income tax payable for the following three consecutive tax years.

Sale of real property

The sale of real property by real estate companies is treated as part of their ordinary income and is subject to corporate income tax at the rate of 30% of their net taxable income. The buyer of the real property may be required to withhold certain CWT, ranging from 0% to 6%, depending on the type of seller/transferor and on the amount of real property sold. The CWT withheld can be used to offset the corporate income tax owed by the real estate company.

The basis of the tax shall be the gross selling price or fair market value of the land and/or building, whichever is higher.

Interest

Deductibility

Only resident foreign corporations, domestic corporations, resident aliens and Filipinos engaged in a trade or business are allowed to deduct interest paid on loans taken out to purchase real property. Furthermore, taxpayers are given the option to treat the interest paid on a loan, to acquire real property used in a trade or business, as either a deductible expense or a capital expenditure which may be depreciated.

However, the amount of interest expense claimed as a deduction shall be reduced by 33% of the interest income earned which had been subjected to final withholding tax. Interest on indebtedness between members of a family is not deductible.

Withholding tax on interest income

Interest income received by residents or non-residents may be subject to withholding tax. The withholding tax rate depends on the source and the recipient of the interest income. Interest earned by resident taxpayers and non-resident aliens engaged in trade or business on Philippine currency deposits with banks in the Philippines is subject to 20% final withholding tax (FWT). Further to this, interest earned by residents on their foreign currency account deposits with banks is subject to 15% FWT.

Long-term bank deposits (ie, with a term of five years or more) of individual residents and non-resident aliens engaged in trade or business in the Philippines are exempt from income tax upon meeting certain conditions. Pre-termination of such deposits before the fifth year shall subject it to FWT at the rate of 5%-20%, depending on the length of time the deposit was held.

Non-resident foreign corporations are subject to 30% FWT on their peso bank deposits and 20% on the interest income derived from foreign-denominated loans extended to residents of the Philippines. The FWT on interest earned by non-resident foreign corporations may, however, be reduced by an applicable tax treaty subject to the filing of a TTRA.

Loss carryforward

Net operating losses can be carried forward for the next three consecutive tax years. For this purpose, the term net operating loss means the excess of allowable deductions over the gross income of the business for that tax year. However, the carryforward will not be allowed if the net loss was incurred when the taxpayer was exempt from

income tax in the year of loss. Furthermore, the carry forward shall be allowed only if there has been no substantial change in the ownership of the business or enterprise in that, if the business is a corporation, not less than 75% of the nominal value of the outstanding issued shares or paid-up capital is held by or on behalf of the same persons. Under the implementing regulations, the change in ownership rule applies to merger, consolidation and business combination.

Capital losses, or losses realised on the sale of capital assets, may only be deducted against capital gains. Capital losses may only be carried over to the succeeding year if the loss is sustained by an individual taxpayer.

Depreciation

Real property should generally be stated at its historical cost. The cost of the real property can be depreciated, the amount or percentage of which should be a reasonable allowance for the exhaustion and wear and tear, including obsolescence, of the property used in a trade or business. However, land cannot be depreciated.

The reasonable allowance for depreciation may be computed under any of the following methods, as prescribed by the Secretary of Finance:

- the straight-line method;
- the declining balance method, using a rate not exceedingly twice the rate that would have been used had the allowance been computed using the straight-line method;
- the sum-of-the-years' digits method.

Computing for depreciation using any other method that may be prescribed by the Secretary of Finance, upon recommendation by the Commissioner may be used.

Value-added tax (VAT)

Sales of real estate by real estate businesses are generally subject to 12% VAT. The VAT shall be based on the gross selling price of the real property sold. Please refer to the previous discussion on sale of real properties held primarily for sale to customers or held for lease in the ordinary course of trade or business.

Pending bills

Currently, there are pending bills to amend the various provisions of the Tax Code particularly with reference to corporate taxes (ie, Packages 2, 3, and 4 of the Comprehensive Tax Reform Program). All three bills have passed three readings at the House of Representatives but are still pending at the Senate level. To become a law, the final version must then be endorsed to the President and then approved.

Package 2 (now known as the "CREATE" Bill) which the President certified to be a priority bill and intended to be passed before the end of 2020, aims among others, to reduce corporate income tax from 30%, the highest in the region, to 25% initially and then gradually to 20% by 2027. Along with this, the bill also proposes to equalise tax treatment by reducing or removing a number of tax and fiscal incentives currently being enjoyed by certain prioritised industries/sectors.

Real estate investment trust (REIT)

The Real Estate Investment Trust (REIT) Act of 2009 defined a REIT as a stock corporation formed for the purpose of owning income-generating real estate assets. It is a type of investment instrument that provides a return to investors derived from the rental income of the underlying real estate asset. A REIT must be registered with the SEC as a stock corporation with a minimum paid-up capital of 300 million PHP.

In the first quarter of 2020, the SEC issued its revised regulations requiring one third minimum public ownership of a REIT. Among others, the revised regulations also require the appointment of a REIT fund manager and property manager and the creation of a related party transactions committee.

The act extended certain incentives to REITs as long as the qualifying conditions are complied with. A REIT that owns land in the Philippines must comply with foreign ownership limitations imposed under Philippine laws. A REIT may also own foreign real estate property, provided that such investment does not exceed 40% of the REIT's deposited property and only upon special authorisation from the SEC.

REITs can enjoy various tax incentives such as, but not limited to, the following:

- dividends distributed that can be claimed as tax deductions;

- not being subject to MCIT;
- a reduced CWT of 1% on income payment to REITs;
- a reduced DST rate and registration fees on sale/transfer of real property including security interest related to REITs (50% of the DST and registration fees);
- an exempt from stock transaction tax (STT) on any initial public offering and secondary offering of shares (STT rate from 1% to 4%);
- 10% final tax on dividends unless a lower treaty rate is applicable; and
- REITs not considered as dealers in securities are not subject to 12% VAT on sale of securities forming part of its real estate related assets. Transfers of property under section 40(c)(2) of the Tax Code or tax-free exchanges are also exempt from VAT.
- Transfers of properties to a REIT are exempt from the 12% VAT, provided that it is in exchange for the shares of the transferee and the transaction would result in an acquisition by the transferor of at least 51% of the outstanding capital stocks of the transferee.

However, to avail of these incentives, a REIT should comply with the following requirements, among others:

- remain a public company as defined in the REIT Law;
- maintain the listed status of its securities;
- submission of a certified Reinvestment Plan and compliance with the same; and
- make an annual distribution of at least 90% of its distributable income to its shareholders.

The Securities and Exchange Commission (SEC), the Philippine Stock Exchange (PSE), and the Bureau of Internal Revenue (BIR) have issued implementing regulations of the REIT Law.

Local tax system in the Philippines

General

In the Philippines, local taxation is a right delegated by the National Government to local government entities, pursuant to the policy of promoting local autonomy. This policy is implemented through the Local Government Code of 1991 (“the Code”) and its implementing rules, which codified and consolidated laws and regulations in connection with the taxing powers of local government entities.

Under the present tax structure, local government entities, through their respective *Sanggunians* (local legislative councils) may levy and collect taxes as specified in the Code, which varies with the kind of local government unit (LGU) concerned. LGUs, from the largest to the smallest unit, are the province, city, municipality and barangay. For instance, a province may levy a tax on transfer of real property ownership, which is not generally allowed for a municipality or a barangay; a municipality may levy a tax on business, which a province cannot levy; while a city may levy taxes that a province or municipality is allowed to levy.

There are a variety of other taxes, fees and charges that may be levied by LGUs under the Code. The rates set out below are the maximum rates of tax prescribed under the Code. However, LGUs have the authority to adjust the prescribed rates once every five years, but in no case shall such adjustment exceed 10% of the rates fixed under the Code. In most cases, local governments have not exercised this authority, so the rates will typically remain within these prescribed ceilings.

In addition to the taxes specifically enumerated in the Code, LGUs may also impose taxes, fees and charges provided they do not overlap with taxes already imposed by the National Government or other applicable laws, and that such additional taxes, fees and charges are not unjust, excessive, oppressive, confiscatory, or contrary to declared national policy.

Following is a summary of the taxes that may be imposed by each LGU, as specified under the Code.

Real property taxes (RPT)

Provinces and cities, as well as municipalities within Metropolitan Manila, are primarily responsible for the levy and collection of the real property tax (RPT).

For purposes of assessment, real property is classified as residential, agricultural, commercial, industrial, mineral, timberland, or special. Cities or municipalities within the Metropolitan Area, through their respective *Sanggunians*, have the power to classify lands in accordance with their zoning ordinances.

All owners of real property are required to file with the provincial, city, or municipal assessor a sworn declaration of the current and fair market value of their real property once every three years. Where any owner fails or refuses to make such a declaration, the assessor concerned shall do so in the name of the defaulting owner.

The basis of the RPT shall be the assessed value of the property, which is computed as a certain percentage (ie, assessment levels based on classification of the real property at rates not exceeding those prescribed under the Code) of the fair market value of the real property (as fixed by ordinances enacted by the *Sanggunians* of the province, city, or municipality concerned). Moreover, real property is classified, valued and assessed on the basis of its actual use, regardless of location, whoever owns it and whoever uses it.

Basic real property tax

A province, city, or a municipality shall fix a uniform rate of basic RPT, applicable to their respective localities, as follows:

- in the case of a province, at the rate not exceeding 1% of the assessed value of real property; or
- in the case of a city or a municipality, at the rate not exceeding 2% of the assessed value of real property.

Special levies on real property

In addition to the basic real property tax, a province, city, or a municipality may impose the following:

- an additional levy for the Special Education Fund (SEF) equivalent to 1% of the assessed value of real property;
- an additional ad valorem tax on idle lands in the form of an annual tax at a rate not exceeding 5% of the assessed value of the property. For this purpose, idle lands include the following:
  - agricultural land exceeding one hectare in area that is suitable for cultivation, dairying, inland fishery and other agricultural uses, 50% of which remains uncultivated or unimproved by the owner of the property or person having legal interest therein. However, an agricultural land planted with at least 50 trees to a hectare or used for grazing purposes is not considered idle land; and
  - non-agricultural land exceeding 1,000 square metres in area and located in a city or municipality, 50% of which remains unused or unimproved by the owner of the property or person having legal interest therein.

A special levy on lands that are especially benefited by public works projects or improvements funded by the concerned LGU shall not exceed 60% of the actual cost of such projects and improvements, including the cost of acquiring the land and such other real property in connection therewith. The special levy will not apply, however, to lands exempt from the basic RPT and to the remainder of the land portions of which have been donated to the LGU concerned for the construction of such projects and improvements.

Local business tax

If the municipality or city in which the company is located does not provide a specific local business tax rate for real estate businesses, the local business tax will generally not exceed 2% of the gross receipts of the preceding calendar year in the case of a municipality, or 3% in the case of a city.

Local transfer tax

Local transfer tax on the sale, exchange, or transfer of real property will generally not exceed 0.5% of the total consideration involved in the acquisition of the property or the fair market value, in case the monetary consideration involved in the transfer is not substantial, whichever is higher, will be assessed.

Other regulatory fees and charges

The LGU may also charge other regulatory fees upon the annual renewal of the business permit (ie, sanitation fees, fire inspection fees, etc), and also impose and collect such reasonable fees and charges for services rendered, public utility charges and toll fees or charges.

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Real Estate Going Global

Poland

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

Rental income

Based on the Polish Corporate Income Tax Law (CIT Law), there is a distinction between "capital gains basket" and "other operational activity basket". Consequently, the taxpayers are now obliged to recognise revenues and costs related to each "basket" separately.

Net income received by corporate taxpayers is taxable in Poland at the general corporate income tax (CIT) rate of 19%. The lower 9% CIT rate applies to income from "other operational activity basket", but only in case of taxpayers:

- who qualify as the so-called "small taxpayers", ie, their revenues from sale including value-added tax (VAT) charged did not exceed the Polish zloty (PLN) equivalent of the amount of 2 million EUR in the previous year; and
- whose revenues for the previous tax year did not exceed the PLN equivalent of 1.2 million EUR.

The real estate rental income should fall into "other operational activity basket".

Generally, all expenses incurred by companies on earning or securing their taxable income, including interest paid, are deductible for CIT purposes (except those costs remaining specifically disallowed in the law) as long as they have been properly documented. As regard the costs of discontinued projects, they may also be deductible for CIT purposes in certain cases (such costs should however be analysed on a case-by-case basis, as the Polish CIT Law does not provide clear guidance in this respect and the standpoint presented by the tax authorities/administrative courts is not homogeneous).

Consolidation for income tax purposes is possible in Poland under specific and relatively strict conditions.

Thin capitalisation rules

The CIT deductibility of financing costs is limited by the deductibility limitation rules. These rules are based on 30% tax EBITDA threshold and are applicable both to related and non-related party (bank) debt financing.

Under these deductibility limitation rules, a taxpayer should exclude from tax deductible costs the part of "debt financing costs" (tax-deductible interest and other financing costs minus taxable interest revenue) exceeding 30% of:

- taxable revenue from all sources, decreased by interest revenue (if any), minus
- tax-deductible costs from all sources, decreased by tax-deductible depreciation write-offs and the so-called "debt financing costs", not included in the initial value of fixed assets/intangible assets,

holistically referred to as tax EBITDA. In principle, in real estate entities tax EBITDA should be similar to NOI.

The above restrictions do not apply to "debt financing costs" to the amount of 3 million PLN in the tax year (approximately 680,000 EUR), so-called "safe harbour". It is not entirely clear whether (i) the "safe harbour" should increase the limit of deductible interest irrespective of the tax EBITDA (ie, 30% of the tax EBITDA plus the "safe harbour" – preferential for taxpayers); or (ii) whether the "safe harbour" is applicable only if higher than 30% of the tax EBITDA (non-preferential, ie, the "safe harbour" or 30% of the tax EBITDA) applies. Generally, the Polish tax authorities are presenting the non-preferential approach in individual tax rulings, while there are some court verdicts presenting the opposite (ie, preferential) approach. Further developments should be observed.

Depreciation

Tax-deductible depreciation of buildings is subject to maximum straight-line rates. Depending on the type of building, these rates generally range from 1.5% to 10% annually.

Usually, non-residential buildings are depreciated over 40 years (using 2.5% tax depreciation rate). Most of non-residential second-hand or improved buildings can be depreciated over a period of 40 years, decreased by the number of full years that elapsed from the day of the building being put into use for the first time until entry thereof into the taxpayer's fixed assets register. Nevertheless, the depreciation period calculated this way cannot be shorter than ten years, ie, 10% is the maximum annual tax depreciation rate.

Land is not subject to tax depreciation. The acquisition costs of land may be recognised as tax-deductible at its disposal.

Loss carryforward

Tax losses carried forward in one "basket" may be utilised over the period of five consecutive years solely to set-off taxable income from the same "basket". Under grandfathering rules, tax losses carried forward from years preceding the entry of the so-called "basketing rules" into force (ie, in principle, before the tax year 2018) may be set-off against any profits, irrespective of the "baskets".

There are two base methods of utilisation of the tax losses:

- Basic method: according to which the tax losses may be carried forward for five consecutive tax years, subject to the restriction that not more than 50% of the tax loss from a given past year can be utilised in any single subsequent tax year.
- Alternative method (applicable only to the tax losses generated in tax years commencing after 31 December 2018): according to which (i) the tax losses may also be set-off with income obtained from the same "basket" during one of the immediately following consecutive five tax years by an amount not exceeding 5 million PLN, while (ii) the amount not utilised may be deducted within the remaining years of this five-year period (however, the amount of such reduction in any of these years may not be higher than 50% of the tax loss). It should be noted, that the "alternative" method cannot be applied to the tax losses from the sale of virtual currencies.

The wording of the law implies that once the basic or alternative method of set-off of tax losses from a given year is chosen, it may not be changed.

Withholding taxes

Dividends

Based on the Polish CIT Law, the WHT rate with respect to dividend payments is 19%, regardless of whether the dividend recipient is a Polish tax resident or not. However, certain WHT exemptions/reduced WHT rates/WHT deductions may be available based on (depending on the case):

(i) the general provisions of the Polish CIT Law;

(ii) provisions of the Polish CIT Law implementing the EU Parent-Subsidiary Directive; and

(iii) the appropriate double tax treaty (DTT).

With respect to dividends paid by the Polish tax-resident companies, the Polish CIT Law is generally in line with the Parent-Subsidiary Directive. Namely, a WHT exemption (the so-called "participation exemption") applies to dividends being paid by a Polish taxpayer to Poland/European Union (EU)/European Economic Area (EEA)/Swiss parent companies, provided that certain level of shareholding is maintained for an uninterrupted period of two years and certain additional conditions are met. Note that this participation exemption, as a rule, does not apply to distributions other than dividends (in particular, since 1 January 2018, liquidation proceeds and remuneration for compulsory or automatic redemption of shares no longer benefit from this exemption).

In case of dividends paid by the non-Polish tax-resident companies to the Polish tax-resident companies, the similar participation exemption applies (under certain conditions).

Based on the specific anti-abuse clause provided in the Polish CIT Law, the participation exemption on dividends does not apply if (a) benefiting from this exemption remains (in given circumstances) contrary to the aim of the exemption; or (b) benefiting from the exemption was the main aim or one of the main aims of the transaction(s)/taxpayer's action(s) and the way in which the taxpayer acted was artificial.

Interest and royalties

The WHT rate on interest and royalties amounts to 20%, unless the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive and/or an appropriate DTT provides for respective WHT exemption/reduced WHT rates. There is no WHT on interest and royalties paid between CIT taxpayers within Poland (and they are generally treated as taxable revenue upon receipt).

Based on the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive, Poland applies a WHT exemption (under certain conditions) for interest and royalties paid to associated companies from the EU/EEA/Switzerland.

The said WHT exemption may be applied to interest and royalties paid to certain related companies (direct shareholders, direct subsidiaries or third companies having the same direct shareholder), provided that certain capital links are maintained for an uninterrupted period of two years and certain other conditions are met.

Intangible services

Payments for services of intangible character (eg, management, consulting services, guarantees) to non-residents are subject to 20% WHT in Poland, unless an appropriate DTT provides for more preferential taxation.

Certificates of tax residence, new WHT regime and beneficial ownership

The application of WHT reliefs (ie, exemptions/reduced WHT rates) with respect to payments to foreign recipients based on the provisions of the Polish CIT Law implementing the EU directives or based on the DTTs is conditional inter alia upon:

- possession by the Polish payer of a certificate of tax residence of the foreign payment recipient; in case of certificates of tax residence which do not specify the period for which they are issued, such certificates should be generally treated as valid for 12 months from the date of issue;
- existence of provisions (in the relevant DTTs) allowing for exchange of tax information between the tax authorities of Poland and the country of the payment recipient.

Please also note that Poland has recently changed the provisions of the Polish CIT Law regarding WHT by introducing the new WHT regime, covering in particular:

(i) the so-called “WHT collect and refund mechanism”; and

(ii) the so-called “due care” obligation of the payers.

In short:

- The “WHT collect and refund mechanism” is applicable by default if the payments subject to WHT per a given entity per tax year exceed the threshold of 2 million PLN. The mechanism assumes that the payer is obliged to collect WHT under the standard rate, as if the WHT exemptions/reduced WHT rates (available based on the provisions of the Polish CIT Law implementing the EU directives or based on the DTTs) did not apply - unless specific conditions are met. In practice, these conditions include (but definitely are not limited to) the beneficial ownership requirement, which (i) is directly stipulated as a condition of applying a WHT exemption based on the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive, while (ii) with respect to WHT reliefs for interest and royalties based on the DTTs, as well as WHT reliefs for dividends and payments for intangible services, this matter is controversial and should be carefully analysed, taking into account the practical approach of the tax authorities).
- As regards the “due care” obligation, it means that the payers are obliged to verify the conditions of applying the WHT exemptions/reduced WHT rates with “due care”, regardless of whether the payments subject to WHT per entity per tax year exceed 2 million PLN or not.

Applicability of the above provisions introducing the new WHT regime is generally suspended until the end of December 2020. However, this suspension does not cover the “due care” obligation, which is already applicable.

For more information, please refer to the chapter “*Real Estate Investments*”.

Taxes on capital

There are no separate capital taxes. However, commercial companies should remember that capital increases are generally subject to notary fees and Civil Law Activities Tax (CLAT) of 0.5%. Loans are generally subject to 0.5% CLAT, but a number of exemptions are available (in particular, exemption for loans granted to the corporation by its direct shareholder).

Capital gains on sale of property

The direct sale of a real property should be recognised in the “other operational activity basket”, while the sale of shares in a company holding real property should be recognised in the “capital gains basket”.

Capital gains on the sale of the real property/shares in a company holding real property are taxed at the general CIT rate of 19%. In case of the direct sale of the real property (which – as mentioned above – qualifies to the “other operational activity basket”), the 9% rate applies for entities qualifying as “small taxpayers” meeting certain

conditions as mentioned above (in case of a sale of shares in a company holding real property, which qualifies to "capital gains basket", this reduced rate is not available). The above rates apply unless otherwise determined by the provisions of an applicable DTT.

Historically, many DTTs concluded by Poland have provided exclusions/exemptions from Polish taxation of capital gains on the sale of shares of Polish real estate holding companies. However, there is a tendency to renegotiate various DTTs and currently more and more of them include the so-called "real estate clause" allowing Poland to tax capital gains on the sale of shares in the Polish companies holding real estate, qualifying as so-called "real estate rich companies". Such provisions were also partly introduced to the DTTs based on the so-called Multilateral Instrument (MLI). Still, some DTTs, including those with the Netherlands and Cyprus, do not contain such clause. Further developments should be observed.

Real estate transfer payments/VAT

The sale of development land is generally subject to VAT at the 23% rate, recoverable under standard VAT rules. The standard 23% VAT rate is reduced to 8% with respect to supply of residential buildings qualifying for the social housing programme.

VAT treatment of sale of developed properties depends on a number of conditions, including classification of the object of transaction as assets on piecemeal basis or a going concern, certain features of the property sold, as well as, to some extent, the decision of the parties to the transaction. Namely, sale of assets on piecemeal basis may be (i) obligatorily taxed with VAT (at the relevant rate); (ii) obligatorily exempt from VAT (ie, subject to the so-called "obligatory VAT exemption"); or (iii) exempt from VAT with the option to tax the supply (ie, subject to the so-called "voluntary VAT exemption"). In case of classification of the object of transaction as going concern, such sale is out of scope of VAT. If the acquisition of real estate (land and/or buildings, constructions) is VAT-exempt or out of scope of VAT, CLAT of 2% is levied. As opposed to VAT, CLAT is not recoverable.

VAT at the rate of 23% is also generally applicable to income from the lease of buildings (with certain exceptions).

VAT on the sale/lease of real properties is generally recoverable by the buyer/tenant as input VAT. However, companies providing exempt services (eg, financial services) are generally unable to recover input VAT.

Charges for the lease or rental of property situated in Poland are subject to Polish VAT, even if the charge is made to a non-resident foreign company.

Anti-abuse and mandatory disclosure rules

A general anti-abuse rule (GAAR) was reintroduced to Polish tax law as of 15 July 2016.

In line with GAAR, the taxpayer's action does not result in a tax benefit if obtaining this tax benefit, which, in given circumstances, remains contrary to the object or aim of the tax act or provision of the tax act, remained main or one of the main reasons for the action, if the way in which given action had been performed was artificial.

The specific Polish GAAR regulations differ in certain aspects from standard set by the EU Anti-Tax Avoidance Directive (EU ATAD)[1], being generally stricter.

Apart from GAAR, the Polish CIT Law also contains specific anti-abuse/anti-avoidance provisions eg, (i) anti-abuse provisions in the Polish CIT Law, covering certain types of transactions (eg, mergers, dividend payments, interest payments); (ii) other anti-abuse provisions in the CIT Law (eg, provisions regarding the so-called "exit tax"); (iii) anti-abuse provisions in other tax acts, eg, in the VAT Law.

In addition, anti-hybrid regulations based on EU ATAD II were implemented and shall be binding as of 1 January 2021.

Poland has also implemented restrictive mandatory disclosure rules (MDR). Under MDR, qualifying promoters, supporters or taxpayers are required to disclose information on reportable arrangements to the authorities. Those regulations are generally stricter than the DAC 6 standard.

In order to be reportable, an arrangement must contain one of 24 hallmarks. Hallmarks cover a wide range of features and the majority of them do not require a tax benefit (ie, the events not involving tax planning may also be reportable).

[1] Council Directive (EU) 2016/1164 of 12 July 2016 laying down rules against tax avoidance practices that directly affect the functioning of the internal market.

Real Estate Investments

Legal considerations

As of 1 May 2016, foreign investors seated in the EEA/Switzerland are in principle free to acquire real estate through entities with a legal personality, partnerships or even through registered branches. However please note, there are regulations providing for limitations relating to acquisition of agricultural land. These regulations generally restrict the possibility to acquire land classified as agricultural (which may be the case even where the land is located in cities) by entities other than individual farmers and a narrow circle of other entities and imposes rather strict conditions for permissibility of agricultural land sale. The above-described agricultural regulations are in force as of 30 April 2016.

The firmest form of title to land is an absolute property ownership (freehold). Another widely encountered form of legal title to land recognised by the Polish Civil Code is perpetual usufruct (lease). It can be established only on land owned by the State Treasury or local authorities.

Perpetual usufruct can be contracted for a fixed period of time, not shorter than 40 years and not exceeding 99 years. Nevertheless, in the last five years of the duration of perpetual usufruct, the person holding the perpetual interest may request for an extension for a further period not exceeding 99 years. Such a request can be rejected only for reasons of important public interest. The perpetual tenant is obliged to pay annual rent, up to 3% of the market value of the real estate, notwithstanding the so-called first fee for leasing the land for perpetual usufruct, which constitutes 15% to 25% of the value of the real estate. The perpetual usufruct agreement can be terminated if the perpetual tenant uses the land in a manner which is obviously contradictory to the purpose specified in the agreement, in particular if the perpetual tenant failed to erect the buildings or facilities specified in the agreement. This mechanism permits creation of a perpetual usufruct interest in land simultaneously with a freehold one, which can be retained by the State or a local authority. This interest can be used effectively in development and investment situations. The perpetual tenant can dispose of its interest in the land without consent of the real estate owner.

The third most common form of title is a short lease. This is a lease granted for a period determined in the lease contract, whether definite or indefinite, where rights and obligations are also open to negotiation between the parties.

Tax considerations

BEPS actions and domestic considerations recently forced substantial and frequent changes in tax legislation, as well as considerable change in approach of tax authorities into more restrictive one.

In Poland, a court ruling is normally binding only for the parties to the case. That is to say, there is not a case law system of universally binding precedents. Nevertheless, court rulings are growing in importance, and published cases are studied by both the tax authorities and tax practitioners. To resolve doubts on specific issues, experts on tax matters should be consulted, or clarification should be requested from the tax authorities. However, it is important to note that the interpretation of the tax laws is constantly changing as new questions are brought to the government's attention, and those seeking to do business in Poland should ensure that the information they have is as up to date as possible.

Anti-abuse regulations

In line with GAAR, the taxpayer's action does not result in a tax benefit if obtaining this tax benefit, which, in given circumstances, remains contrary to the object or aim of the tax act or provision of the tax act, remained main or one of the main reasons for the action, if the way in which given action had been performed was artificial.

As a rule, individual tax rulings shall not provide protection in case GAAR is applied. In this respect, the Tax Ordinance provides for a new tax clearance instrument, ie, so-called "protective opinion" which is issued by the Head of National Revenue Administration (NRA). The protective opinion is issued if the circumstances presented in the motion for issuance of the protective opinion indicate that the tax benefit described in the motion is not subject to GAAR. In case of the motions for issuance of the protective opinions, the Head of NRA analyses the case more deeply than in case of individual tax rulings (eg, tax ruling fully relies on the descriptions of the backgrounds presented by the taxpayers).

Similarly, as mentioned in the chapter "*Real Estate Tax Summary*", except GAAR the following aspects should also be taken into account when speaking about anti-abuse/anti-avoidance: (i) specific anti-abuse/anti-avoidance provisions provided in the Polish tax laws (in particular, in the CIT and VAT Laws); as well as (ii) MDR.

Related-party transactions

The tax regulations contain rules to prevent the abuse of transfer pricing, both international and domestic, as well as specific rules for the market valuation of consideration in kind. Thin capitalisation rules are also in place.

Intangible services – Limitation on tax deductibility of costs

Since 1 January 2018, there is a limitation on tax deductibility of costs of certain intangible services rendered by related parties or entities from territories deemed as tax havens.

The restrictions cover in particular (but are not limited to): (i) intangible services (including advisory, market research, advertising services, management and control, data processing, insurance, guarantees, etc); (ii) royalties (including inter alia licences, trademarks and know-how).

Restrictions may affect the excess over 3 million PLN (approximately 680,000 EUR) plus 5% of tax EBITDA (which calculation slightly differs from calculation of tax EBITDA for interest limitation). Costs exceeding this limit and – accordingly – excluded from tax deductible costs in a given year could be carried forward to five subsequent years (still subject to the above restrictions).

In specific situations, the limitations should not apply. This covers (but is not limited to) in particular: (i) costs of intangible services, payments and fees classified as tax deductible costs and directly related to manufacturing or acquisition of goods/provision of services by a taxpayer (the matter of a "direct relation" is however not precisely regulated in the Polish CIT Law, which in practice leads to interpretative disputes); and (ii) costs of intangible services rendered by related party which are subject to an Advance Pricing Agreement (APA).

Tax rulings, APAs and opinions

The Tax Ordinance generally provides for two types of rulings which may be issued by the tax authorities: general tax rulings and individual tax rulings.

General tax rulings are issued by the Minister of Finance, generally ex officio (ie, on his own initiative), but the taxpayers are allowed to request for issuing such rulings in case of discrepancies in interpretation of the law by the local tax authorities. General tax rulings are not addressed to any specific recipient and – as a rule – the conclusions presented thereon relate to all taxpayers.

Individual rulings are issued by the Head of National Revenue Information (NRI). Generally, the individual tax ruling should be issued within three months of filing the application for the ruling (however, currently this term is temporarily extended due to COVID-19). The Head of NRI is entitled to prolong this period if, in his view, a taxpayer causes delay, eg, if the actual state or the taxpayer's standpoint presented in the application is not sufficiently clear. If the deadline is not met – either the original mentioned in the Tax Ordinance or the prolonged one – it is assumed that the Head of NRI appraises the standpoint presented in the taxpayer's application as correct.

The individual tax ruling provides protection only to the entity which requested the ruling. However, if the same factual state or future event applies to two or more taxpayers (eg, parties to the same transaction), they may submit a joint application for an individual tax ruling. In case an application for an individual tax ruling covers matters in relation to which a general tax ruling had already been issued (in the same state of legislation), the tax authorities shall deny issuing individual tax ruling and confirm that the general tax ruling should be applied to the taxpayer's case. Note that while the taxpayer may challenge individual tax ruling in court, there is no such possibility with respect to general tax rulings.

The ruling is not binding to other tax authorities (eg, tax offices and fiscal control offices) from the formal point of view. Nevertheless, according to the law, compliance with the interpretation should not lead to any harm to the taxpayer, ie, the taxpayer should not be obliged to pay any penalty interest or be subject to fiscal-penal responsibility, even if the tax authorities do not agree with the ruling in their proceedings. Only in the case where negative tax implications result from compliance with the ruling that covers future transactions, will the taxpayer also be free of tax.

Under the GAAR regulations, if under description of the case presented by the taxpayer the tax authorities have a reasonable presumption, that GAAR could apply, the Head of NRI shall deny issuing an individual tax ruling. Additionally, even if the Head of NRI issues such a ruling, the taxpayer is not protected.

Entities performing related party transactions may also apply to the Head of NRA for APAs available under certain conditions.

Certain other protective instruments, such as eg, (i) the so-called “protective opinions”; or (ii) the opinions on applicability of WHT exemptions (“WHT Opinion(s)”), are also available under the Polish tax law.

Late payment of taxes

The standard penalty interest rate for late payment of taxes is calculated based on the formula stipulated in the Tax Ordinance based on the National Bank of Poland interest rates and currently amounts to 8% per annum (which is the minimum provided for in the law).

In case of the tax arrears arising after 31 December 2015, the standard rate may be reduced by 50% (ie, to 4% per year taking into account the current standard rate) provided that the taxpayer: (i) voluntarily corrects the tax return within six months; and (ii) pays the tax arrears within seven days following the correction (with some exceptions). In case of the tax arrears which arose before 1 January 2016, the standard rate may – if voluntarily disclosed (and under some additional conditions) – be reduced by 25% (ie, to 6% per year taking into account the current standard rate).

On the other hand, in certain cases of VAT/excise duty arrears stipulated in the Tax Ordinance, the standard rate is increased by 50% (ie, to 12%). As a rule such an increase applies (i) if the tax authorities reveal (in the course of tax audit, tax and customs audit or tax proceedings) that the taxpayer understated the tax liability/overstated the tax overpayment/did not file the tax return and pay the tax resulting thereof; or (ii) where the taxpayer corrects the tax return after: (a) receiving notice of a tax audit/the end of the tax audit; (b) made as a result of the “checking activities”; or (c) receiving an authorisation to perform the tax and customs audit – provided that the amount of understated liability/overstated overpayment/refund exceeds both 25% of the amount due and five times the minimum wage.

Since 1 January 2017, there is also a specific VAT “sanction”, ie, additional VAT liability applicable broadly if a taxpayer unrightfully deceased its VAT liability or increased VAT refund, amounting (as a rule) to 30% of such VAT liability decrease/VAT refund increase. The VAT sanction may also apply if a taxpayer did not submit its VAT return and did not pay corresponding liability at all. In certain cases, in particular if the VAT liability decrease/VAT refund increase results from so-called “empty invoices” issued by non-existent entities or documenting transactions which did not take place (VAT frauds), the VAT sanction amounts to 100%.

Please also note that – based on the Tax Ordinance – in certain cases, the tax authorities alongside late payment interest impose additional tax liability on a taxpayer. The rates applicable/calculation methods differ depending eg, on the reason for imposing the additional tax liability, the type of the respective tax, etc.

Legal implications

Real estate permits

According to provisions of Act on Acquiring Real Estate by Foreigners, purchase of Polish real estate by foreign investors (companies and individuals) generally requires a permit issued by the Minister of Internal Affairs and Administration. However, this general rule does not apply to acquisitions made by investors of the EEA and Switzerland.

A permit from the Minister of Internal Affairs and Administration is subject to stamp duty of approximately 400 EUR. The procedure for a foreign-owned company to obtain such a permit is relatively straightforward, yet it may take up to three or six months and requires providing certain documents and information.

In addition, permits from the Minister of Internal Affairs and Administration are required for the acquisition of a stake in a Polish company that owns real estate or holds it in perpetual usufruct, if as a result of the purchase of shares, the company in question will become a controlled company, in the meaning of the Polish Act on Acquiring the Real Estate by Foreigners, or the company in question is already such a controlled company, and the stake is acquired by a foreign investor who is not yet a stakeholder.

The obligation to obtain the above permit does not apply to the acquisition of a stake in a Polish company that owns real estate or holds it in perpetual usufruct by investors of the EEA and Switzerland.

Such a permit is also subject to stamp duty of approximately 400 EUR.

The permits mentioned above are valid for two years. A promise of a permit (which is valid for one year) may also be obtained.

Acquisition of Polish real estate without a permit, if such a permit is required, is invalid by the virtue of law.

Restrictions on acquisition of agricultural land

The Law on the Shaping the Agricultural System provides for limitations relating to acquisition of land classified as agricultural (even where the land is located in cities).

The restrictions do not apply to agricultural land (i) designated for purposes other than agricultural in the local masterplan adopted by municipal council; (ii) with a total area not exceeding 0.3 hectare; as well as (iii) such land which – as of 30 April 2016 – was designated for such other purposes based on final zoning permits.

The regulations generally restrict the possibility to acquire such land (ownership or perpetual usufruct right) of an area equal to or exceeding 1 hectare by others than individual farmers, State Treasury, local authorities, churches and close relatives of the seller.

Other entities will be permitted to acquire agricultural land only in specific cases and – in principle – based on decisions issued by the National Support Centre for Agriculture (KOWR).

Additionally, the buyer of agricultural land will be obliged to run (in case of a natural person – "in person") a farm (part of which is formed by the acquired property) for five years and – in principle – would not be allowed to sell this real property/give it into use of third parties. This restriction does not apply inter alia to the acquisition of agricultural real property of an area smaller than 1 hectare which is located within administrative boundaries of the city.

Moreover, the KOWR has the pre-emption rights covering the acquisition of:

- ownership/perpetual usufruct of the real estate of agricultural character (with some exceptions, in particular, the Centre does not have the pre-emption right when it issued the decision permitting to acquire agricultural land);
- shares in a company being an owner and/or perpetual usufructuary of agricultural land with a total area equal to or exceeding 5 hectares (but in case of inter alia (i) sale of shares in entities operating on the regulated market; as well as (ii) sale made to close relatives of the vendor, State Treasury, Centre's pre-emption rights would not be applicable). In case of acquisition of shares based on other transaction than the agreement on sale of shares, the Centre is entitled to buy out shares.

Additionally, the KOWR has the right to make a statement on the acquisition of a real estate of agricultural character, in particular in case of the acquisition of such real estate:

- based on agreement other than sale agreement (eg, in-kind contribution agreement, exchange agreement, donation);
- based on unilateral legal act;
- based on the decision of the court of administrative body;
- as a result of a merger, de-merger or transformation.

The above right of the KOWR (to make a statement on acquisition of a real estate of agricultural character owned/held in perpetual usufruct by the company) also applies in case of change of the partner or joining by new partner of the partnership being owner or perpetual usufructuary of agricultural land.

The acquisition of the real estate in breach of the above regulations is invalid by virtue of law.

Separate regulations apply to "agricultural portfolio of the state". Until 30 April 2021, real properties (and parts thereof) constituting the so-called "agricultural portfolio of the state" cannot be subject to sale. This general rule does not apply inter alia to the real properties (and parts thereof):

- intended (based on the provisions of local development plan/final zoning permit) for aims other than agricultural (including inter alia technology/industrial park or storehouses);
- located in special economic zones;
- constituting agricultural properties of an area not exceeding 2 hectares.

Anti-monopoly consent

Under certain conditions, the President of the Polish Anti-Monopoly Office should be notified of enterprises' concentrations (mergers, takeovers, creation of a joint-venture, and purchase of a part of the target's assets). Generally, an intention to concentrate must be reported if it involves enterprises whose aggregate worldwide turnover exceeds the equivalent of 1 billion EUR or whose aggregate turnover in Poland exceeds the equivalent of 50 million EUR in the financial year preceding the notification.

Choice of entity

Foreigners from the EU Member States, Member States of the European Free Trade Agreement (EFTA) – parties to the Agreement on the EEA – and foreigners from the states not being parties to the Agreement on the EEA who may enjoy freedom of establishment under agreements concluded by those States with the European Community and its Member States, may undertake and carry on economic activity on the same terms as Polish citizens.

In case of other foreigners, subject to reciprocity, unless international agreements ratified by Poland provide otherwise, foreigners can undertake and carry on economic activity on the territory of Poland on the same terms and in the same forms as the Polish entrepreneurs.

There are generally two groups of entities recognised in Poland: partnerships and commercial companies. Commercial companies are separate legal entities and their shareholders are not liable for the company's obligations, while in case of the partnerships, in general, at least some of the partners have unlimited liability for the partnership's obligations.

At present, Polish commercial law allows for the formation of the following types of vehicles open to foreign investors:

- registered partnership;
- limited partnership;
- joint-stock partnership;
- limited liability company;
- joint-stock company.

In the absence of reciprocity, foreigners (subject to certain exemptions) may form only limited partnerships, joint-stock partnerships, limited liability companies and joint-stock companies, or they may join such partnerships and companies and take up or acquire their shares.

Apart from establishing Polish companies, a foreign investor may also operate on the Polish market via a registered branch, which may be allowed to carry out economic activities in Poland. The main activities of the registered branch of a foreign entity may comprise the development and/or lease of real estate in Poland, provided that such activities are also performed by that foreign entity.

Below we briefly outline the key features of the above presented vehicles.

Registered partnership

A registered partnership is based on the provisions of the Commercial Companies Code. The partners have unlimited liability, and the partnership is not a legal person, yet may acquire the rights and assume the obligation on its own.

The concept of legal personality separates business operations and liabilities resulting from activity of that legal person from the property of partners. As a consequence, partners in the registered partnership are jointly and severally liable with regard to all liabilities and obligations of the partnership, without any limit, to the whole of their estate.

Limited partnership

A limited partnership is a specific form of a registered partnership. A limited partnership has at least one partner who is responsible for the management of the partnership and has unlimited liability. The other partner or partners have limited liability and are liable only to the extent indicated in limited partnership's Articles of Association. Additionally, the limited partner is exempt from the above liability up to the value of the contribution made to the limited partnership. A limited partnership is not a legal person.

Joint-stock partnership

A joint-stock partnership is a partnership of a hybrid character, the legal construction of which is based on selected regulations concerning a limited partnership and a joint-stock company. A joint-stock partnership should have at least one partner who bears unlimited liability for the partnership's obligations, ie, the general partner, and the other partner, the shareholder, whose responsibility for the partnership's obligations is excluded, and who may represent the partnership only as its proxy. Both general partners and shareholders are entitled to participate in the partnership's profits in proportion to their contributions. A joint-stock partnership does not have legal personality.

Limited liability company

A limited liability company is the most frequently used entity for specific investment in Poland when the shares in the company are not intended for public subscription. In the case of large investments that require a public profile and may lead to a listing or public raising of capital, formation of a joint-stock company would be advisable.

Establishment of a limited liability company is, however, much more straightforward than establishment of a joint-stock company. Furthermore, a limited liability company may be established by a sole shareholder, unless this shareholder is a limited liability company having only one shareholder.

The minimum share capital required for the establishment of a limited liability company amounts to approximately 1,250 EUR.

Joint-stock company

A joint-stock company is more suitable for large investments that require a public profile, and that may lead to a listing or public raising of capital, since it is perceived on the local market as being a more substantial entity than a limited liability company.

The minimum share capital required for the establishment of a joint-stock company amounts to approximately 25,000 EUR.

Closed-end investment fund

In the past, closed-end investment funds (FIZ) – in combination with certain partnerships – were a popular vehicle for investing suitable for larger portfolios.

FIZ is a distinct type of legal person, which should not be associated with a company, partnership or contractual arrangement. Technically, the fund is not a subsidiary of the investors and their rights result from the possession of investment certificates issued by FIZ. The fund is managed by an external investment fund management company, but it is possible for the investors to keep economic control over the assets of the FIZ.

Tax implications

Buying and selling property

Capital gains

The direct sale of a real property should be recognised in the “other operational activity basket”, while the sale of shares in a company holding real property should be recognised in the “capital gains basket”.

Capital gains from a direct sale of a real property/going concern are combined with other business income of the taxpayer within the “other operational activity basket” and taxed at the general CIT rate of 19% (9% for “small taxpayers” meeting certain conditions as mentioned in the chapter “*Real Estate Tax Summary*”). On the other hand, capital gains from a sale of shares in a Polish real estate rich entity are subject to 19% CIT in a separate “basket”, ie, the “capital gains basket”, unless otherwise determined by the provisions of an applicable DTT.

Historically, many DTTs concluded by Poland provide exclusions/exemptions from Polish taxation of capital gains on the sale of shares of Polish real estate holding companies. However, there is a tendency to renegotiate various DTTs, introducing, among others, changes in taxation of sales of shares in real estate companies. Generally, new or recently renegotiated DTTs feature a clause for the application of Polish tax on the sales of shares in a company deriving most of its value from real estate located in Poland (while the general rule is non-taxation of such profits in Poland). Still, some DTTs including those with the Netherlands and Cyprus, do not contain such a clause.

In any case, foreign companies are subject to Polish CIT at the standard tax rate on capital gains realised on the sale of Polish real estate.

Value-added tax (VAT) and transfer taxes

Initial comments on the sale of real property

The Polish VAT/CLAT implications of the sale of the real property depend on whether the object of a transaction consists of:

- undeveloped land; or

- buildings and/or constructions along with the plots of land on which they are located.

Irrespective of the above, the taxation also depends on whether the sold assets are classified as a going concern (an enterprise or an organised part thereof) or assets on a piecemeal basis.

Object of a transaction consisting of undeveloped land

The sale of undeveloped land designated for construction purposes is generally subject to VAT at the 23% rate, recoverable under standard VAT rules.

The sale of undeveloped land other than the above is VAT-exempt.

Object of a transaction classified as assets on a piecemeal basis

The sale of real estate property classified as assets on piecemeal basis is usually subject to VAT at the 23% rate payable by the seller (for more details, please see below), if effected (i) before or within so-called "first occupation"; or (ii) within less than two years after the first occupation. The VAT is effectively financed by the buyer as part of gross purchase price and in many cases fully recoverable by the latter. The "first occupation" is understood as:

- giving into use of the buildings, constructions or their parts (after their construction or improvement amounting to at least 30% of the initial value) to the first purchaser or the first user (eg, via sale, lease, etc); or
- starting using the buildings, constructions or parts thereof for own purposes.

Under this definition, the real property may be subject to "first occupation" more than once (eg, the new "first occupation" may take place after improvement of the real estate provided that the improvement value exceeds 30% of the initial value).

After the two-year period from the „first occupation", sale by default is VAT-exempt under so-called "voluntary VAT exemption". The parties to the transaction are entitled to jointly resign from the voluntary VAT exemption and choose to impose VAT on the transaction (provided that certain conditions are met).

The sale effected (i) before or within the so-called „first occupation"; or (ii) within less than two years from the first occupation may:

- either be taxed with VAT; or
- be subject to the so-called "obligatory VAT exemption" (which applies to supplies of buildings, constructions or their parts, not subject to the voluntary VAT exemption, provided that: (i) in relation to these buildings, constructions or their parts, the vendor was not entitled to decrease the output VAT by the amount of input VAT; and (ii) the vendor has not incurred improvement costs related to the supplied buildings, constructions or their parts, with respect to which they were entitled to recover input VAT or such improvement costs were lower than 30% of initial value of the supplied buildings, constructions or their parts.

  The latter condition is not applicable in case the improved buildings, constructions or their parts have been used by the taxpayer for at least five years for the purposes of effecting taxable activities.

If the sale remains exempt from VAT, 2% CLAT calculated based on fair market value (FMV) of real estate, shall be levied on the buyer. CLAT will not be recoverable for the buyer.

Object of a transaction classified as a going concern

On the other hand, the sale of a going concern is out of scope of VAT, but subject to 2% CLAT on the FMV of real property as well as other tangible items and 1% CLAT on other assets. CLAT is not recoverable.

In this context, transactions classified as sales of assets on a piecemeal basis are market preference.

Proper classification

Classification of the object of the transaction as going concern or sale of assets on a piecemeal basis is judgmental. Until mid-2016, commercial real deals were typically classified as sales of assets on a piecemeal basis – what was often confirmed in individual rulings of the Polish tax authorities.

In mid-2016, Polish tax authorities started challenging classification of the object of the transaction and denying recovery of input VAT to the taxpayers, hence the market generally switched to enterprise deals (subject to 2% CLAT). However, certain court verdicts confirmed correctness of the previous practice. On 11 December 2018, the Polish Ministry of Finance issued official guidelines on transfer tax treatment of commercial real estate deals in Poland (MF Guidelines). The MF Guidelines were intended to clarify whether a given set of assets constitutes: (i) a going concern (an enterprise/organised part thereof); or (ii) assets on a piecemeal basis, thus, to provide investors with more comfort in this respect.

MF Guidelines

Based on our understanding of the MF Guidelines, the Ministry of Finance leans strongly towards classification of commercial real property deals as deals concerning assets on piecemeal basis, while transactions involving the going concerns should rather be seen as exceptions in specific cases.

The MF Guidelines provide that to consider a transaction as covering a going concern (enterprise/organised part thereof), a buyer must factually continue business activities of a seller using the same set of assets, without need to engage additional ones and taking additional actions.

Other aspects

With respect to supply of residential buildings qualifying for social housing programme, the VAT rate amounts to 8% (instead of 23%).

Construction services are generally subject to VAT at the standard 23% rate. The exception to this rule is 8% VAT rate applicable to construction services connected with real estate, covered by a social housing programme.
It should also be noted that construction services are generally subject to an obligatory split payment mechanism.

In some cases (eg, when the property is used for the purpose of non-VAT-able activity), deducted input-VAT on creation (ie, construction) or acquisition of real properties may be subject to obligatory corrections (ie, pay back to the tax office) within correction period stipulated in the Polish VAT law.

Use of separate property holding companies

It is a common practice to hold properties in separate special purpose companies. Disposals are effected by sale of shares in such companies.

The taxation of capital gains on disposal of shares in real estate holding companies, and WHT treatment of various payments may differ depending on where the holding company is located. The business justification should be held for choice of holding company. Such holding company should also demonstrate adequate level of substance. In this context, beneficial owner requirements, as well as anti-abuse provisions should be carefully analysed.

Financing real estate in Poland

Debt

Interest deductions

Generally, interest on loans should be tax deductible on a cash basis (ie, when paid or, based on established practice, capitalised to a loan principal), provided that the loan:

(i) is used to earn or secure sources of taxable revenues;

(ii) has been provided on “arm’s length” terms;

(iii) does not fall into thin capitalisation limitations;

(iv) is not subject to limitations under EU ATAD II (ie, in short, does not result in a hybrid mismatch); and

(v) is not listed in the tax law as non-tax deductible.

Thin capitalisation

The CIT deductibility of financing costs is limited by the deductibility limitation rules. These rules are based on 30% tax EBITDA threshold (implementation of the EU ATAD) and are applicable both to related and non-related party (bank) debt financing.

Under these deductibility limitation rules, a taxpayer should exclude from tax deductible costs the part of “debt financing costs” (tax-deductible interest and other financing costs minus taxable interest revenue) exceeding 30% of:

- taxable revenue from all sources, decreased by interest revenue (if any), minus
- tax-deductible costs from all sources, decreased by (i) tax-deductible depreciation write-offs and (ii) the so-called “debt financing costs” not included in the initial value of fixed assets/intangible assets,

holistically referred to as tax EBITDA. In principle, in real estate entities tax EBITDA should be similar to NOI.

The above restrictions do not apply to “debt financing costs” to the amount of 3 million PLN in the tax year (approximately 680,000 EUR), so-called “safe harbour”. It is not entirely clear whether (i) the “safe harbour” should increase the limit of deductible interest irrespective of the tax EBITDA (ie, 30% of the tax EBITDA plus the “safe harbour” – preferential for taxpayers); or (ii) whether the “safe harbour” is applicable only if higher than 30% of the

tax EBITDA (non-preferential, ie, the “safe harbour” or 30% of the tax EBITDA) applies. Generally, the Polish tax authorities are presenting the non-preferential approach in individual tax rulings, while there are some court verdicts presenting the opposite (ie, preferential) approach. Further developments should be observed.

Transfer pricing considerations

Transfer pricing rules are applicable to loans. Loans must bear market terms, including a market rate of interest. Poland, as a member of the Organisation for Economic Co-operation and Development (OECD), has adopted the “arm’s length” standards enumerated in the OECD Transfer Pricing Guidelines.

Transfer pricing regulations also apply to permanent establishments (PEs) of foreign entities.

Other considerations

Interest on loans drawn in order to acquire shares is, as a rule, tax-deductible. However, the timing of deductibility of such interest (at the moment of payment or at the moment of subsequent disposal of shares) is not specifically regulated in the Polish CIT Law.

Interest on construction loans accrued during the construction period must be capitalised to the value of the development and depreciated. Interest accrued after bringing the asset into use is tax-deductible on a cash basis.

Loans are generally subject to CLAT of 0.5% of the amount of the loan. Loans made by banks and other loans subject to VAT are CLAT exempt. Please note that in Poland it is somehow disputable whether all loans granted by entrepreneurs should be considered as granted within VATable activity and thus exempt from CLAT.

Moreover, loans granted to corporations by their direct shareholders are also CLAT-exempt.

In some cases, the cross-border loans are required to be reported to the relevant authorities (eg, to the National Bank of Poland).

Please note that payments between the Polish residents can be agreed and settled in a foreign currency.

Equity

Equity funding allocated to registered share capital is subject to CLAT at the rate of 0.5%. Share premium (agio) should not be subject to CLAT. It is recommended that business justification is held for allocation ratio between share capital and share premium.

The equity contribution of the investor may be made either in cash or in kind. The company may, however, also be provided with non-equity capital such as additional payments (subject to certain restrictions) or loans.

Operating real estate

Rental income

Net income received by corporate taxpayers falls into “other operational activity basket” and is taxable in Poland at the general CIT rate of 19% (9% for “small taxpayers” meeting certain conditions as mentioned in the chapter “*Real Estate Tax Summary*”).

Generally, all expenses incurred by companies on earning or securing their taxable income, including interest paid, are deductible for CIT purposes (except those costs specifically disallowed in the law) as long as they have been properly documented. Consolidation for income tax purposes is possible in Poland under specific and relatively strict conditions.

Depreciation

The CIT Law provides for standard depreciation rates depending on the type of asset. Thus, it is possible for differences to arise between accounting and tax-deductible depreciation.

Generally, taxpayers can use two basic methods of depreciation: straight line (for all assets) and reducing balance (selected assets, mostly machinery and equipment, using a coefficient not higher than 2).

Within the straight-line method:

- The Polish tax law provides inter alia for accelerated depreciation for assets used in conditions of intensive use (the assets is considered being subject to intensive use if it is used more intensive than in average conditions or subject to exceptional technical demands).
- On the other hand, the taxpayers may individually decrease the depreciation rates for fixed assets, upon their entry into the fixed assets register or as of the beginning of a given tax year.

Tax-deductible depreciation of buildings is subject to maximum straight-line rates. Depending on the type of building, these rates generally range from 1.5% to 10% annually (in case of certain second-hand buildings).

Usually, non-residential buildings are depreciated over 40 years (using 2.5% tax depreciation rate). Most of non-residential second-hand or improved buildings can be depreciated over a period of 40 years, decreased by the number of full years that elapsed from the day of the building being put into use for the first time until entry thereof into the taxpayer's fixed assets register. Nevertheless, the depreciation period calculated this way cannot be shorter than ten years, ie, 10% is the maximum annual tax depreciation rate.

Land is not subject to tax depreciation. The acquisition costs of land may be recognised as tax-deductible at its disposal.

Loss carryforward

Tax losses carried forward in one "basket" may be utilised over the period of five consecutive years solely to set-off taxable income from the same "basket". Under grandfathering rules, tax losses carried forward from years preceding the entry of the so-called "basketing rules" amendments into force (ie, in principle, before the tax year 2018) may be set-off against any profits, irrespective of the "baskets".

There are two base methods of utilisation of the tax losses:

- Basic method: according to which the tax losses may be carried forward for five consecutive tax years, subject to the restriction that not more than 50% of the tax loss from a given past year can be utilised in any single subsequent tax year.
- Alternative method (applicable only to the tax losses generated in tax years commencing after 31 December 2018): according to which (i) the tax losses may also be set-off with income obtained from the same "basket" during one of the immediately following consecutive five tax years by an amount not exceeding 5 million PLN, while (ii) the amount not utilised may be deducted within the remaining years of this five-year period (however, the amount of such reduction in any of these years may not be higher than 50% of the amount of the tax loss). It should be noted that the "alternative" method cannot be applied to tax losses from the sale of virtual currencies.

The wording of the law implies that once the basic or alternative method of set-off of tax losses from a given year is chosen, it may not be changed.

Taxes on capital

There are no separate capital taxes. Companies should, however, remember that capital increases are, generally, subject to notary fees and 0.5% CLAT (share premium is not subject to CLAT).

Property tax/Real estate tax

A local annual property tax is levied on real property, also called real estate tax (RET). The RET rates are dependent on the location, type and purpose of a property, and are applied to the area (in case of land and buildings) or value (in case of constructions/structures).

The maximum RET rates for property used for business purposes for the year 2020 may not exceed the following:

- 0.95 PLN per square metre of land;
- 23.90 PLN per square metre of buildings;
- 2% of the value of constructions/structures.

Minimum tax

Minimum tax (also called "tax on commercial properties" or "minimum CIT", or MinCIT) is a special type of tax on kind of "deemed" taxpayer's income from buildings, ie, initial value of the taxpayer's buildings, decreased by 10m PLN ; approximately 2.3 million EUR. Please note that the provisions on the application of 10 million PLN "safe harbour" have been subject to changes between 2018 and 2019 – as in principle in 2018 the "safe harbour" could be used with respect to (deducted from) the initial value of each of taxpayer's buildings, while as of 2019 the "safe harbour" may be used (deducted) only once regardless of the number of taxpayer's buildings.

The basic principles regarding MinCIT are as follows:

- MinCIT is calculated separately from the "regular" CIT.

- MinCIT was first introduced in 2018 as a tax relating only to specific types of commercial buildings, while – due to the changes introduced as of 2019 – since then all types of commercial buildings subject to lease/tenancy are subject to MinCIT.
- MinCIT base is generally the initial value of the buildings/parts thereof (located in Poland, owned or co-owned by a taxpayer and subject to lease/tenancy), decreased by 10 million PLN. As mentioned above, as a rule currently the "safe harbour" of 10 million PLN may be used (deducted) by the taxpayer only once. Additionally, it should be noted that in certain cases this "safe harbour" (amount) is even shared with taxpayer's related parties (while the definition of a "related party" is not entirely clear). In case the building is only partially leased, the MinCIT base is calculated proportionally to the leased usable floor space (and MinCIT is not due if the leased floor space ratio is below 5%).
- In case of buildings subject to operational/financial leasing (as defined in the CIT Law), MinCIT is payable by entity depreciating the building.
- MinCIT is payable on a monthly basis, at the rate of 0.035% (which roughly translates to the rate of 0.42% per annum).
- The taxpayer may either decrease CIT liability by value of paid MinCIT or not pay MinCIT if the CIT liability exceeds value of MinCIT. Therefore, in practice MinCIT, results in additional tax burden only if: (i) no regular CIT is paid by the taxpayer; or (ii) taxpayer's regular CIT is lower than the MinCIT.
- MinCIT may be refunded to taxpayer on an annual basis and the conditions of the refund are as follows: (i) the taxpayer files the refund request; (ii) the tax authority does not identify any irregularities regarding the amount of regular CIT liability/loss (indicated in the CIT return) and the amount of MinCIT paid.

VAT

VAT at the rate of 23% is generally applicable to income from the lease of buildings. This is generally recoverable by the tenant as input VAT. However, companies providing exempt services (eg, financial services) are generally unable to recover input VAT.

Charges for the lease or rental of property situated in Poland are subject to Polish VAT, even if the charge is made to a non-resident foreign company.

Withholding taxes

Dividends

Based on the Polish CIT Law, the WHT rate with respect to dividend payments is 19%, regardless of whether the dividend recipient is Polish tax resident or not. However, certain WHT exemptions/reduced WHT rates/WHT deductions may be available based on (depending on the case):

(i) the general provisions of the Polish CIT Law;

(ii) provisions of the Polish CIT Law implementing the EU Parent-Subsidiary Directive; and

(iii) the appropriate DTT.

Note that the WHT exemption under the EU Parent-Subsidiary Directive, as a rule, does not apply to distributions other than dividends (in particular, since 1 January 2018, liquidation proceeds and remuneration for compulsory or automatic redemption of shares no longer benefit from this WHT exemption).

Outbound dividends (dividends paid by Polish taxpayers to foreign taxpayers)
As mentioned above:

- the standard CIT rate for dividend payments made by the Polish taxpayers to the foreign taxpayers is 19%;
- this may be modified, in particular by the WHT exemptions/reduced WHT rates, which may be available under the Polish CIT Law and DTTs (provided that certain conditions are met).

As regards WHT exemption for such dividends based on the Polish CIT Law implementing the EU Parent-Subsidiary Directive, the key conditions of applicability thereof (which should be met jointly) are as follows:

- dividend payer has the seat or management on the territory of Poland;
- dividend recipient has its worldwide income (irrespective of the place where it is derived) subject to taxation in the EU, EEA, or Switzerland;

- dividend recipient holds directly at least 10% of shares in the dividend payer for an uninterrupted period of at least two years (in case of the dividend payments made to the Swiss taxpayers, the required direct shareholding amounts to at least 25%);
- dividend recipient is not exempt from tax on all its income, regardless of its source.

Please note that:

- the conditions listed above are the key ones, while the Polish CIT law contains further conditions/requirements/clarifications in this respect.
- based on the specific anti-abuse clause provided in the Polish CIT Law, the participation exemption on dividends does not apply if (a) benefiting from this exemption remains (in given circumstances) contrary to the aim of the exemption, or (b) benefiting from the exemption was the main aim or one of the main aims of the transaction(s)/taxpayer's action(s) and the way in which the taxpayer acted was artificial.

Domestic dividends (dividends paid between Polish companies)
In case of Polish CIT taxpayers who receive dividends from domestic companies, the taxation rules are similar as in case of dividends between a Polish CIT taxpayer and foreign CIT taxpayers. The major exception is that in case of dividends between Polish CIT taxpayers the WHT reliefs under the DTTs are not available.

In short, in case of dividends between Polish CIT taxpayers:

- the standard CIT rate is 19%;
- certain WHT deductions/WHT exemption based on the Polish CIT Law may be available (under certain conditions);
- as regards WHT exemption under the CIT Law, the key conditions thereof are similar as in case of dividends paid by a Polish taxpayer to a foreign taxpayer (in particular, the condition of a minimum 10% shareholding applies).

Inbound dividend (dividends paid by foreign taxpayers to Polish taxpayers)
In case of dividends paid by the foreign taxpayers to Polish CIT taxpayers:

- In principle they are included in Polish taxpayer's income and taxed with 19% CIT.
- The proportional part of the tax paid in connection to these dividends in a foreign country may be deducted under certain conditions from the Polish CIT liability;
- Additionally, under certain conditions (in particular, the minimum shareholding of 10%), the CIT exemption may be applied.

Interest and royalties

The WHT rate on interest and royalties amounts to 20%, unless the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive and/an appropriate DTTs provide for the WHT exemption/reduced WHT rate. There is no WHT on interest and royalties paid between CIT taxpayers within Poland and they are generally treated as taxable income upon receipt.

Based on the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive, Poland applies a WHT exemption (under certain conditions) for interest and royalties paid to associated companies from other EU/EEA Member States. The key conditions of applying the said WHT exemption (which should be jointly met) are as follows:

- The recipient has the seat or management on the territory of Poland.
- The recipient has its worldwide income (irrespective of the place where it is derived) subject to taxation in an EU or EEA Member State (other than Poland);
- The recipient has a direct minimum holding of 25% in the capital of the payer company, or the payer has a direct minimum holding of 25% in the capital of the recipient, or a third company has a direct minimum holding of 25% both in the capital of the recipient and in the capital of the payer (and the minimum holding period is two years).
- The recipient is not exempt from tax on all its income, regardless of its source.
- the beneficial ownership status of the recipient.

Please note that:

- the conditions listed above are the key ones, while the Polish CIT law contains further conditions/requirements/clarifications in this respect;
- based on the specific anti-abuse clause provided in the Polish CIT Law, this WHT exemption does not apply if (a) benefiting from this exemption remains (in given circumstances) contrary to the aim of the exemption; or (b)

benefiting from the exemption was the main aim or one of the main aims of the transaction(s)/taxpayer's action(s) and the way in which the taxpayer acted was artificial.

Intangible services

Payments for services of intangible character (eg, management, consulting services, guarantees) to non-residents are subject to 20% WHT in Poland, unless appropriate DTT provides otherwise.

Certificates of tax residence, new WHT regime, beneficial ownership

Certificates of tax residence/Exchange of information

The application of WHT reliefs (ie, exemptions/reduced WHT rates) with respect to payments to foreign recipients based on the provisions of the Polish CIT Law implementing the EU directives or based on the DTTs is conditional inter alia upon:

- possession by the Polish payer of a certificate of tax residence of the foreign payment recipient (in case of certificates of tax residence which do not specify the period for which they are issued, such certificates should be generally treated as valid for 12 months from the date of issue);
- existence of provisions (in the relevant DTTs) allowing for exchange of tax information between the tax authorities of Poland and the country of the payment recipient.

New WHT regime

Please also note that Poland has recently changed the provisions of the Polish CIT Law regarding WHT by introducing the new WHT regime, covering in particular:

- the so-called "WHT collect and refund mechanism";
- the so-called "due care" obligation of the payers.

In short:

- The "WHT collect and refund mechanism" is applicable by default if the payments subject to WHT per a given entity per tax year exceed the threshold of 2 million PLN. The mechanism assumes that the payer is obliged to collect WHT under the standard rate (ie, depending on the payment, 19% or 20%, respectively), as if the WHT exemptions/reduced WHT rates (available based on the provisions of the Polish CIT Law implementing the EU directives or based on the DTTs) did not apply unless specific conditions are met. In practice, these conditions include (but definitely are not limited to) the beneficial ownership requirement, which (i) is directly stipulated as a condition of applying a WHT exemption based on the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive, while (ii) with respect to WHT reliefs for interest and royalties based on the DTTs, as well as WHT reliefs for dividends and payments for intangible services, this matter is controversial and should be carefully analysed, taking into account the practical approach of the tax authorities).
- As regards the "due care" obligation, it means that the payers are obliged to verify the conditions of applying the WHT exemptions/reduced WHT rates with "due care", regardless of whether the payments subject to WHT per entity per tax year exceed 2 million PLN or not.

Applicability of the above provisions introducing the new WHT regime is generally suspended until the end of December 2020. However, this suspension does not cover the "due care" obligation, which is already applicable.

Please find below further information on both the new WHT regime and the beneficial ownership requirements.

Payments not exceeding 2 million PLN/recipient/tax year
Should the payments subject to WHT/entity/tax year not exceed the threshold of 2 million PLN, the payer (remitter) will still be entitled to apply WHT relief (assuming that the conditions for applying WHT exemption/reduced WHT rate are met). The WHT remitter is however obliged to act with "due care" while applying WHT exemptions/rate reductions resulting from EU directives/DTTs, which in practice includes inter alia verification of the beneficial ownership status of payment recipient (please find below further remarks on the beneficial owner). Please note that the applicability of the beneficial ownership requirement is in practice controversial as:

- the beneficial ownership requirement is directly stipulated as a condition of applying a WHT exemption based on the provisions of the Polish CIT Law implementing the EU Interest and Royalties Directive, while
- with respect to WHT reliefs for interest and royalties based on certain DTTs, as well as WHT reliefs for dividends and payments for intangible services, such requirement is not (directly) provided for in the tax law, however, it seems that the tax authorities tend to apply an approach, according to which the beneficial ownership requirement also applies to these payments; in other words, this matter is controversial and should be carefully analysed, taking into account the practical approach of the tax authorities).

Payments over 2 million PLN/recipient/year
Should the payments subject to WHT/entity/tax year exceed the threshold of 2 million PLN, a "collect-and-refund" mechanism will principally apply, ie,

- the Polish the payer (WHT remitter) cannot apply any WHT reliefs resulting from EU directives/DTTs; and
- should collect the Polish WHT at the domestic rate (ie, 19 % or 20%, depending on a given payment) on the part of the payments subject to WHT exceeding 2 million PLN (ie, on the excess over 2 million PLN).

In the above case, the non-resident payment recipient (ie, the taxpayer) or the Polish payer (WHT remitter, if he paid WHT using his own funds and incurred the economic burden thereof) will be entitled to claim WHT refund. In order to get a refund, the applicant should submit the respective motion to the tax authorities with a number of documents attached thereto. As a rule, the tax authorities should refund the WHT within six months from the date of receipt of the application. However, this deadline can be prolonged if the grounds for the refund require further investigation.

Notwithstanding the above, there are certain cases in which the Polish payer will be entitled to apply WHT relief to payments subject to WHT (per foreign recipient per tax year) exceeding 2 million PLN, ie,

- with respect to WHT reliefs based on EU directives: if the special statement (Remitter's Statement) is filed by the Polish WHT remitter or specific formal opinion on applicability of WHT exemption (ie, WHT Opinion) is obtained by the foreign recipient (taxpayer) or the Polish payer (WHT remitter);
- with respect to reliefs based on DTTs: if the Remitter's Statement is filed by the Polish WHT remitter (it is not possible to obtain the WHT Opinion in this respect).

As regards Remitters Statement, the key information is as follows:

- It must be signed by the remitter’s management board members (with no possibility of signing via proxies).
- It should include a confirmation that (i) the Polish payer completed appropriate verification that conditions for the given WHT relief were fulfilled and holds adequate documents certifying that applying WHT exemption/reduced WHT rate is justified; and (ii) after performing the respective verification (with due care/diligence), the Polish payer is not aware of any circumstances prohibiting application of WHT exemption or reduced WHT rate.
- If it is deemed false/untrue, the person(s) signing Remitter's Statement may be subject to a fiscal penalty and additional 10% (or 20%, if certain threshold is exceeded) tax liability may be applicable to the remitter.

As regards WHT Opinion:

- while analysing specific cases, the tax authorities perform thorough verification of the motions and documents provided by the applicants; and
- the WHT Opinion shall be issued within six months from the date of application (in practice, however, the tax authorities tend to prolong this period) and, in principle, be valid for 36 months.

Beneficial ownership

As of 2019, the new definition of beneficial owner was introduced into the Polish CIT Law, according to which the beneficial owner is an entity that meets the following conditions:

1. receives a receivable (payment) for its own benefit and decides independently about the way of utilisation of the receivable (payment) and bears the economic risk due to total or partial loss of the receivable (payment);
2. does not act as intermediary, proxy, trustee or any other entity that is (legally/actually) obliged obliged to transfer the relevant payment (in whole or in part) to another entity; and
3. conducts a real business activity in the country of its registered seat, if receiving a receivable (payment) is obtained in the course of that business activity. In order to assess whether the entity conducts a real business activity, the provisions concerning the real business activity (for the purposes of controlled foreign companies) should apply accordingly, ie, it should be analysed, whether in particular:
   - the recipient of the payment (interest) has an enterprise with which it actually carries out business activities (especially if it has premises, qualified personnel and equipment used for the business activities carried out);
   - the recipient does not function without economic reasons in the structure;
   - there is a balance between the scope of activities carried out by the entity and its premises, personnel, and equipment;
   - arrangements made by the entity are in line with economic reality, have business reasons and are not clearly contrary to the general economic interest of the entity;

– the recipient autonomously carries out its basic economic functions using its own resources, including management persons present in the place where the entity is located.

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Real Estate Going Global

Portugal

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

Corporate and individual investors planning to invest in real estate located in Portugal may opt between indirect acquisition (ie, through investment vehicles), or direct acquisition.

Rental income

Resident companies and branches, ie, permanent establishments (PEs) of non-resident companies, when obtaining net rental income, are taxed at the main corporate income tax (CIT) rate of 21%, plus a local surtax (*derrama municipal*), which is levied by several municipalities in Portugal, of up to 1.5% of taxable profit, not considering any tax losses carried forward.

State surtax (*derrama estadual*) also accrues as follows:

(i) 3% for taxable profit between 1.5 million EUR and 7.5 million EUR;

(ii) 5% for taxable profit above 7.5 million EUR and up to 35 million EUR; and

(iii) 9% for taxable profit above 35 million EUR.

Resident companies and branches are allowed to deduct interest, depreciation charges and other property expenses such as taxes and duties paid. Taxation is levied on an accrual basis.

Non-resident companies carrying out passive investments, in general, are not deemed to have a PE in Portugal. Net rental income, determined on a cash basis, will be taxed at the income tax rate of 25%. They are allowed to deduct expenses effectively incurred, paid and properly documented, in order to obtain rental income. Interest, depreciation charges, furniture, household appliances, decoration and comfort accessories cannot be deducted.

Depreciation

According to the local GAAP, which follows the IFRS rules, real estate classified as an investment property can be valued under the cost model or fair value model. The option for one or the other model may result in different financial and tax results.

In case the company opts for booking the investment property at cost, it should be depreciated for tax purposes, at the 2% annual rate for flats or apartments, offices and commercial property and at the 5% annual rate for industrial buildings or hotels. Depreciation is calculated under the straight-line method.

Land cannot be depreciated for tax purposes.

The property should also be subject to an impairment test and, if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.

If any impairment loss related to the property is recognised and not deductible for tax purposes in the year on which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.

No accounting depreciation charge is allowed in case the company opts for booking the investment property at fair value. Nevertheless, for tax purposes, investment property valued at fair value may be tax depreciated throughout the maximum period of its useful lifetime (ie, 100 years), at the rate of 1% per annum. The basis for tax depreciation corresponds to the acquisition/construction cost, disregarding any fair value variations.

Capital gains on the sale of property

Capital gains arising on the sale of property by tax resident companies and PEs of non-resident companies are subject to the main CIT, at the rate of 21%. The final tax rate for a company may increase if local and state surtaxes are levied.

Reinvestment relief mechanism is not available in the case of investment property.

Any capital gain arising from the sale of property located in Portugal when owned by a non-resident entity without PE in Portugal is taxable at the rate of 25%.

Additionally, capital gains shall be liable to tax in Portugal, whenever they result from the transfer of share capital or similar rights in any entity (non-resident in Portuguese territory), when, in any given time in the past 365 days, the value of those shares or rights result, directly or indirectly, in more than 50% of immovable property or rights in rem over immovable properties located in the Portuguese territory (except if related to agricultural, industrial and commercial activity and not the sale and purchase of immovable property).

Loss carryforward

The carryforward period for tax losses generated from 2014 to 2016 is 12 years. For tax losses generated in 2017 onwards, the carry forward period will be five years. Losses can be used to offset net operating income and capital gains realised on the sale of property located in Portugal.

The deduction of tax losses is limited to 70% of the taxable profit of the year, with the possibility of carrying forward the remaining 30% in future years within the established carry forward period (12 or five years).

Nevertheless, the company loses the right to keep on carrying forward the tax losses in the year when there is a change of more than 50% of the share capital or the majority of the voting rights of the company. Mere company reorganisations within the same group are not considered changes of ownership of share capital for the purposes of this rule.

The Portuguese Tax Administration may nevertheless authorise upon a request submitted by the company within 30 days upon the transfer of the shares.

Under the Supplementary State Budget Law for 2020, the Government puts forward the following changes:

(i) The deadline for reporting tax losses generated in 2020 and 2021 is extended to 12 tax years (currently the deadline for reporting is five tax years).

(ii) Increase the tax loss deduction limit from 70% to 80%, when the difference stems from tax losses incurred in 2020 and 2021.

(iii) Disregarding the 2020 and 2021 tax years when calculating the deadlines for tax loss reporting for the 2020 tax year.

Real Estate Investments

Direct investments in Portuguese property

General

The Portuguese real estate market is open to the investment of non-nationals and non-residents, which can become, as referred, owners of real estate assets by direct ownership or through legal entities (ie, through the purchase of shares in a company owning real estate assets).

If the investment is to be made through the acquisition of real estate assets through legal entities, it is mandatory to proceed with the registration of the beneficial owner in order to comply with the measures in force regarding anti-money laundering and anti-terrorism financing.

The main tax issues arising from direct investments are addressed in this section.

Given the fact that tax liabilities regarding property taxes may follow the property, it is generally advisable to conduct a tax due diligence review on the target property. In such due diligence, property taxes and charges and the value-added tax (VAT) status should be checked. If necessary, the seller should be asked for certain guarantees on possible tax liabilities.

In addition to the absence of restrictions on foreign investment, several measures were approved in recent years for Portugal to attract foreign investment (namely a “Golden Visa Program” and a more favourable tax regime for non-habitual residents).

Legal aspects

Property right

According to the Portuguese law, property right is an exclusive and complete right to possess, use and dispose of an asset, under the limitations imposed by the law. When concerning urban or rustic properties, such right also includes the space above the property, as well as the subsoil, with everything thereof contained.

This right is especially protected by the Portuguese Constitution, which guarantees private property and its transmission during life or *mortis causa* and that, as a matter of principle, expropriation in the public interest can only be carried out against payment of fair compensation.

Usually, the transmission of the property right over certain real estate asset occurs through the execution of a sale and purchase agreement before a public notary (ie, by means of a public deed) or through an authenticated document and, afterwards, registered with the Land Registry Office.

However, as a first step and before the public deed is executed, a promissory sale and purchase agreement is usually concluded between the seller and the buyer. This type of agreement entails an obligation to sell and an obligation to buy and, therefore, implies a reciprocal undertaking between the parties of the agreement. Under certain circumstances, if one of the parties does not comply with the promissory sale and purchase agreement, it is possible to claim the specific performance of the transaction (*execução específica*) before a court. The promissory sale and purchase agreement may also be executed by means of a public deed or, alternatively, by an authenticated document, being, in this case, and after duly registered with the Land Registry Office, enforceable against any third parties.

If the potential buyer does not intend to be obliged to purchase the real estate asset, a purchase option agreement shall be considered. Under the same, the owner of the real estate asset undertakes to, during a certain period of time, sell the property (object of the agreement) to the buyer, if the same declares his/her/its will to proceed with the acquisition. Such an agreement does not bind the potential buyer to proceed with the acquisition. If the buyer declares his/her/its will to acquire the real estate asset in due time, the transaction shall be completed by means of a public deed or an authenticated document. If not, the seller is free to sell the real estate asset to a third party. This mechanism may also apply, *mutatis mutandis*, to a sell option agreement.

Administrative licenses

In order to proceed with the transaction of a real estate asset, it is usually necessary to present:

(i) a use permit issued by the competent municipality; and

(ii) an energy performance certificate.

Additionally, regarding properties for residential purposes built after March 2004, the technical document of the house (*ficha técnica de habitação*) must also be presented.

Condominium regime

If a building is composed by different independent units, the same may be subject to the condominium regime.

Under this regime, each owner of the different units will be also co-owner of the common areas that compose the building (such as the entrances, roof and the structure of the building).

The incorporation of a property under this regime may be executed by means of a public deed or an authenticated document and typically will occur at the same time of the approval of the condominium regulations. The incorporation title of the condominium (*título constitutivo da propriedade horizontal*) contains the terms and conditions for the use of the common areas and sets out the rules for the management of the building.

Additionally, it contains a formula to determine the amount that each unit shall pay regarding the maintenance of the common parts of the building, services, and common costs. The incorporation title of the condominium must be duly registered with the Land Registry Office.

Some other rights over real estate assets

In addition to the acquisition of the property right over a real estate asset, there are other minor rights that may be created over real estate assets. Although it is not an exhaustive list, we would like to highlight the following rights:

(i) Surface right (direito de superfície): consists in the right to build and maintain a building or use and enjoy a building located on or over a plot of land owned by a third party and that can be established for a limited period of time or in perpetuity;

(ii) Usufruct (usufruto): consists in the right to use and obtain the benefits of a third party's property for a certain period of time, that cannot exceed the lifetime of the beneficiary of the right in case the same is a natural person or 30 years if the beneficiary is a legal entity;

(iii) Time-sharing (direito real de habitação periódica): consists in the right over an accommodation unit in aparthotels, tourist villages or touristic units that can be used by the beneficiary of the same during a limited period each year, being exploited for touristic purposes by third parties the remaining time;

(iv) Permanent housing right (direito real de habitação duradoura): gives one or more natural persons the right to use another person's property as their permanent residence for their lifetime, subject to payment to the owner of the property of (i) a security; and (ii) periodic payments.

Town planning regulations

If the investor acquires a plot of land for construction or intends to carry out larger works in a building that already exists, the same will be subject to the planning and zoning regulations applicable, that bind public entities, private entities and individuals.

In addition to the general rules arising from the law, there are municipal plans that establish the allowed use for certain areas according to the purpose of the buildings (residential, commerce and services, industry, agriculture, etc).

Municipalities are responsible for the draw and approval of the municipal plans for land and zoning and to evaluate the compliance of any project with the municipal regulations.

The performance of works aiming to the construction of a new building or significant alterations to an existing one is subject to licensing.

If intended, it is possible to file a prior information request with the municipality in order to obtain an official statement on the feasibility of the project.

Finally, the use of real estate assets is, with few exceptions, subject to a use permit to be issued by the competent municipality.

Lease agreements

Lease agreements of real estate assets can follow under two regimes: urban lease regime and rural lease regime. With respect to urban leases, it may be distinguished between residential and non-residential urban leases.

It is relevant to point out that, under Portuguese law, the maximum initial lease term is 30 years and the minimum term is one year. However, under certain circumstances, the minimum term can be set aside by the parties.

Also, and unless the parties agree otherwise, in order to sublease the real estate asset, the landlord's prior written consent is mandatory, otherwise the landlord may terminate the agreement based on tenant's default.

Tax aspects

Depending on the status of the owner of property located in Portugal, whether an individual or a corporate entity, resident or non-resident, the taxable basis of income derived from property will be determined according to Portuguese domestic tax law.

Similarly, with respect to transaction taxes, property transfer tax (IMT), stamp duty and VAT rules may apply on any property transaction in Portugal.

Corporate tax

Resident companies

Under Portuguese tax law, companies that have their head office or place of effective management in Portugal qualify as Portuguese residents for tax purposes and are therefore subject to Portuguese CIT on their worldwide income.

The taxable income of Portuguese resident companies is subject to the main CIT rate of 21%, plus a local surtax (*derrama municipal*), which is levied by several municipalities in Portugal, of up to 1.5% of taxable profit, not considering any tax losses carried forward.

State surtax (*derrama estadual*) also accrues as follows:

(i) 3% for taxable profit between 1.5 million EUR and 7.5 million EUR;

(ii) 5% for taxable profit above 7.5 million EUR and up to 35 million EUR; and

(iii) 9% for taxable profit above 35 million EUR.

The basis of the taxable income is the gross income realised on the property, less allocable expenses and depreciation. Allocable expenses include repair, maintenance, renovation and similar costs, and interest expenses on loans taken out to finance the respective acquisition. Tax depreciation charges are allowed.

Capital gains or capital losses realised on the sale of property are treated as part of the company's taxable income for CIT purposes. Capital gain or capital loss realised corresponds to the difference between the sales price, net of inherent charges, and acquisition cost, (net of tax impairment losses and accumulated tax depreciation charges) updated by an official monetary correction index (for real estate held over two years).

Please note that when the sales price of the property is lower than its tax registration value (TRV), the seller must either:

(i) adjust the annual CIT return for the amount corresponding to the positive difference between the TRV and the amount stipulated in the sales agreement; or

(ii) prove to the Portuguese Tax Administration that the price of the transaction was effectively lower than the TRV of the building.

A reinvestment relief mechanism is not available in case of investment property.

The accounting rules applicable to statutory accounts (SNC) are in line with the International Financial Reporting Standards. According to the SNC, property classified as investment property it may be valued according to the following criteria:

- cost model; or
- fair value model.

The main features of the cost model for tax purposes are:

- Depreciation: The property will be subject to annual depreciation, under the straight line method, which is deductible for tax purposes (eg, up to a maximum of 2% per annum for commercial property), except the part regarded as land.
- Impairment loss: Property should also be subject to an impairment test, and if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.
- If any impairment loss related to the property is recognised and not deductible for tax purposes in the year in which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.
- Future sale of the property: In such case, the computation of any capital gain results from the difference between the sales price minus the acquisition cost (net of any accumulated tax-deductible depreciation charges and impairment losses that have already been considered as deductible for tax purposes) updated by an official monetary correction index (for real estate held over two years).

The main features of the fair value model for tax purposes are:

- Depreciation: Tax depreciation is allowed, throughout the maximum period of the investment property's useful lifetime (ie, 100 years), at the rate of 1% per annum. The basis for tax depreciation corresponds to the acquisition/construction cost.
- Fair value variations: Any variations on the fair value of the property will be accounted for in the company's profit and loss account. These variations are not relevant for taxation purposes.
- Future sale of the property: In such case, the computation of any capital gain results from the difference between the sales value minus the acquisition cost net of any accumulated tax-deductible depreciation charges updated by an official monetary correction index (for real estate held over two years).

Depreciation rates for property may vary between 2% and 5%, depending on the type of property, eg, 2% annually for flats or apartments, offices and commercial property; 5% annually for industrial buildings or hotels. Land and the capitalised expenses related to it cannot be depreciated. If the land value is not known or determinable, it is deemed to account for 25% of the acquisition cost of the property.

The carry forward period for tax losses generated in 2013 was of five years. From 2014 to 2016 the carry forward changed to 12 years. For tax losses generated in 2017, the carry forward period will be five years. The deduction of tax losses is limited to 70% of the taxable profit of the year, with the possibility of carrying forward the remaining 30% in future years within the established carry forward period.

The Supplementary State Budget Law for 2020 stipulates that tax losses generated in 2020 and 2021 can be carry forward for a period of 12 years.

Additionally, not only the 70% deduction limit is increased by 10%, when the difference results from the deduction of tax losses calculated in the 2020 and 2021 tax periods, but also the counting of the carry-forward period, applicable to tax losses in force as at the first day of the 2020 tax period, is suspended during 2020 and 2021. Nevertheless, the company loses the right to keep on carrying forward the tax losses in the year when there is a change of more than 50% of the share capital or the majority of the voting rights of the company. Mere company reorganisations within the same group are not considered changes of ownership of share capital for purposes of this rule.

This holds true unless the Portuguese Tax Administration, upon a request submitted to the Ministry of Finance within 30 days upon the transfer of the shares, authorise otherwise.

Non-resident companies

Under Portuguese corporate tax law, distinction has to be made between non-residents with a permanent establishment (PE), and non-residents without a PE located in Portugal.

PEs of non-resident entities are subject to similar CIT rules to those applicable to Portuguese resident entities. Hence, the basis for the taxable income of entities investing in Portuguese property is the gross income, including capital gains realised on the property, minus allocable expenses and depreciation (if applicable).

For non-residents without a PE in Portugal, income derived from property located herein will be subject to CIT as follows:

- Rents received will be subject to a provisional 25% withholding tax (WHT), where the entity paying the income is required to have accounts and bookkeeping. The tax withheld corresponds to an advanced payment on account of the final tax due, with the final rate of 25% applicable. Tax refunds for the difference are allowed. Where the rents received are paid by entities not required to have accounts and bookkeeping, no provisional WHT is levied.

- Capital gains realised on the disposal of property will be subject to the 25% CIT rate.
- When owned by an entity resident for tax purposes in a tax haven, according to a list published by the Government (tax haven entity), unused property or property not allocated to an economic activity is always deemed to be let and, consequently, generating rental income. For tax purposes, the deemed annual gross rental income is one-fifteenth of the TRV. This rule is not applicable where the tax haven entity is able to demonstrate that the property is not used by an entity domiciled in Portugal and is indeed vacant.

Personal income tax

Resident individuals

Individuals resident in Portugal are liable for personal income tax on their income arising worldwide.

In general terms, a person is deemed to be tax resident in Portugal if one of the following conditions is met:

- more than 183 days are spent in Portugal in any 12-month period starting or ending in the fiscal year concerned; or
- having spent less than 183 days in Portugal, a person maintains a residence suggesting being a habitual residence in Portugal in the above 12-month period.

Depending on the circumstances, the splitting of the tax year may be applicable, ie, a taxpayer can be considered as tax resident only during a part of the year.

An individual that transfers its tax residency to a country or jurisdiction listed as a tax haven is also deemed to be tax-resident in Portugal in the year of the transfer and in the following four years, unless the individual is able to prove that there are good reasons for that transfer, such as the carrying out of a temporary activity for a Portuguese company.

The general principle is that resident individuals investing in property located in Portugal are subject to personal income tax on the income allocated to the property. Nevertheless, a distinction has to be made between individuals carrying out a business undertaking, and individuals owning properties outside the scope of a business undertaking.

In the former case, the taxable income is determined under the rules applicable to Portuguese resident companies (see section "*Direct investments in Portuguese property*/*Corporate tax*"). Tax losses arising from the business undertaking can be carried forward to offset profits arising from the same business undertaking within the subsequent five years.

Taxable income is subject to progressive tax rates, which vary between 14.5% and 48%, depending on the respective tax bracket. In addition, an additional solidarity rate of 2.5% on the taxable income between 80,000 EUR and 250,000 EUR and of 5% on taxable income exceeding 250,000 EUR may be due.

In the case of individuals obtaining income from property located in Portugal, which does not qualify as profits of a business undertaking, these are subject to personal income tax as follows.

The concept of property rent is defined by the tax law in very broad terms and includes, among other items, fees for services provided in relation to leased property, lease of equipment, fixtures and fittings installed in the leased property, etc.

Tax may be withheld, on the rent, depending on the tax status of the entity paying it. While rents paid by companies, entrepreneurs or independent professionals required to have accounts are subject to a 25% provisional WHT, no provisional WHT applies in the case of rents paid by non-professional individuals.

Net rental income is subject to taxation at the rate of 28%. Or if the individual opts to add such rental income to its remaining income, they will be subject to progressive tax rates.

Capital gains realised on the disposal of property is equal to the difference between sales price and acquisition cost. Duly documented improvement expenses, incurred in the previous twelve years, plus costs inherent to the disposal are added to the acquisition cost. In order to exclude purely nominal or inflationary gains, the acquisition cost is multiplied by the official monetary devaluation index. The capital gains obtained are subject to tax in 50%.

Capital gains and capital losses should be included in the annual income tax return, and they are subject to progressive tax rates, which vary between 14.5% and 48%, depending on the respective tax bracket. In addition, an additional solidarity rate of 2.5% on the taxable income between 80,000 EUR and 250,000 EUR and of 5% on taxable income exceeding 250,000 EUR may be due.

Non-resident individuals

Non-resident individuals are subject to personal income tax on the capital gains arising from the sale of property located in Portugal, at the autonomous rate of 28%.

Net rental income for non-resident individuals is subject to an autonomous rate of 28%.

Residents from another country of the European Union (EU) or of the European Economic Area (EEA) may opt to have their capital gains or rental income taxed at the same rates as Portuguese residents, ie, between 14.5% and 48%, depending on the respective tax bracket (for residents in the EEA, the country in question must have a tax information exchange in place with Portugal). In addition, an additional solidarity rate of 2.5% on the taxable income between 80,000 EUR and 250,000 EUR and of 5% on taxable income exceeding 250,000 EUR may be due. However, to calculate the applicable tax rate, the individual's worldwide income is taken into account, as for Portuguese resident individuals.

Double tax treaties (DTTs) concluded by Portugal grant Portugal the right to tax income derived from property located in Portugal.

Property taxes

Property transfer tax (*imposto municipal sobre as transmissões onerosas de imóveis*, or IMT)

IMT is levied on the transfer of ownership of property located in Portugal. The IMT rates vary according to the type of use of the real estate:

(i) 6%, in case of residential real estate above 550,836 EUR and up to 1,000,000 EUR or 7.5% if above 1,000,000 EUR;

(ii) 6.5%, in case of other urban real estate such as retail, offices or land for construction; and

(iii) 5%, in case of rural land.

In relation to the acquisition of residential property, the 6% rate may be reduced if the purchase price does not exceed a certain amount, which is updated every year. Full exemption is also available for lower amounts (in 2020 less than 92,407 EUR).

When the acquirer is an entity domiciled in a tax haven jurisdiction (not an individual), IMT is levied at a rate of 10%.

IMT is applied to the higher of the purchase price or the official TRV, appraised under the annual local property tax (IMI) rules. This tax is borne by the acquirer, whether resident or non-resident in Portugal.

For IMT purposes, we list below several actions that are deemed transfers of property:

- Promissory sale or exchange of property agreements in which the economic ownership transfer of the properties occurs.
- Letting of property for more than 30 years.
- Direct acquisition of at least 75% of the share capital of private limited liability companies, general partnerships, or limited partnerships that own property, located in Portugal. This rule is also applicable to direct acquisition of at least 75% of the units of close ended real estate investment funds.
- Irrevocable powers of attorney related to property acquisitions or share capital of limited liability companies in the conditions stated above.
- Transfer of contractual position foreseen in promissory sale agreement.

Several exemptions from this tax are available, in particular, for the following situations:

- Operations qualifying as company restructuring or cooperation projects, which are:
  - mergers;
  - split-ups or spin-offs through transfer to a newly established company of all the assets of other companies, which are allocated to a technically independent business, provided that the transferor ceases to engage in the corresponding activity, upon previous request and approval;
  - the acquisition by an existing company, under certain conditions, of all the assets of other companies, which are allocated to a technically independent business, provided that the transferors cease to engage in the corresponding activity.
- The acquisition of property bound for resale by real estate trading companies (resale of properties) may also benefit from IMT exemption. The acquirer needs to demonstrate to the tax administration that is acquiring the property for resale and is acting in its normal course of business. Further, for this purpose, the same property has to be sold within three years, and the new purchaser may not acquire it for resale again.

Stamp duty

As a general rule, stamp duty is levied on the transfer of property ownership at 0.8%. The taxable basis is the purchase price, or the TRV appraised under IMI rules, if higher.

However, if the transfer of property is subject to VAT (by means of waiving the VAT exemption), it is not subject to stamp duty.

Annual local property tax (*imposto municipal sobre imóveis*, or IMI)

IMI is the municipal tax levied on the ownership of property. The tax is due by the owner of the property on 31st December of each year.

According to the IMI rules, the TRV of the urban properties is updated on a triennial basis, based on 75% of the official monetary devaluation index.

IMI is levied on the definitive assessed TRV of land and buildings located within each municipality. The corresponding rates are:

- rural property: 0.8%;
- urban property: 0.3% to 0.45%;
- tax resident in a tax haven owning urban property in Portugal, except for individuals: 7.5%.

The applicable rates for urban property held by either Portuguese residents or non–residents (but not residents in a tax haven), can be tripled annually in the event that the building is unoccupied for over one year or in ruins.

Several IMI exemptions are available. Among others, we highlight the following:

- property owned by the state and other state-owned entities (in certain cases);
- houses or flats considered as permanent places of abode;
- buildings qualified as historical property;
- historical stores, recognised by the municipalities as establishments of historical, cultural or social interest and that integrate the national inventory; and
- property acquired by property trading companies under certain conditions.

This tax is allowed as a deduction in the computation of corporate tax, for companies owning and using land or buildings for their business undertaking.

Additional to the IMI (AIMI)

AIMI is due by individuals and corporations, as well as by structures or collective bodies without autonomous legal personality and undivided inheritances, that are owners, usufructuaries or have the surface right of urban properties located in Portugal, intended for residential purposes and land for construction.

The taxable basis corresponds to the sum of the TRV of all the urban properties held by each taxpayer, reported as at 1st January of each year.

Properties that benefited from IMI exemption or were not subject to IMI in the previous year are excluded from the taxable basis.

This tax is allowed as a deduction in the computation of corporate tax, for companies owning and using land or buildings for their business undertaking.

In case of individuals and undivided inheritances, a deduction of 600,000 EUR to the taxable basis is foreseen. Married or living in non-marital partnership taxpayers, who opt to submit a joint tax return, have the right to deduct 1.2 million EUR.

In case of individuals, the following rates apply:

- 0.7% for properties with a taxable basis (after deductions) not exceeding 1 million EUR (or 2 million EUR in case of married or living in non-marital partnership taxpayers, who opt to submit a joint tax return for AIMI purposes); and
- 1% for the part of the taxable basis that between 1 and 2 million EUR (except if the taxpayer is married or living in a non-marital status and opts to be taxed jointly with its partner, in which case such amounts double);
- 1.5% for the part of the taxable basis that exceeds 2 million EUR (except if the taxpayer is married or living in a non-marital status and opts to be taxed jointly with its partner, in which case such amounts double).

In case of properties owned by corporations, the rate of 0.4% on the taxable basis is applicable.

However, in case of properties intended for the personal use of its shareholders or other members of the management and supervisory bodies of such corporation, the applicable rates are:

- 0.7% for the taxable basis up to 1 million EUR;
- 1% for the part of the taxable basis that exceeds such amount and that is equal or lower than 2 million EUR; and
- 1.5% for the taxable basis that exceeds 2 million EUR.

Properties owned by entities domiciled in a tax haven, the additional to the IMI is levied at the rate of 7.5%.

AIMI can be used as a tax credit up to the fraction of the personal income tax due on the rental income, whether such income is taxed as rental income or is added to the remaining income and liable to progressive tax rates.

The personal income tax credit is also applicable to the taxpayers that obtain business and professional income related to accommodation or business activities.

AIMI can be used as a tax credit up to the fraction of the CIT related to income obtained from lease and lodging activities. In this case, the AIMI expense will not be considered for the determination of the taxable income.

Urban rehabilitation

Legal aspects

In Portugal, the owners of buildings/units are subject to a duty of conservation of the same. According to the law, it is mandatory to perform conservation works at least every eight years. If a building is in danger of collapsing, the municipality may order its demolition.

Also, there are some situations where urban rehabilitation should be performed under specific frameworks, namely when it comes to buildings with a certain historic/cultural value.

Tax aspects

The Portuguese Urban Rehabilitation Regime provides tax incentives for the rehabilitation of properties that started on or after 1 January 2008 and are concluded by 31 December 2020.

The property subject to rehabilitation must fulfil certain requirements related to its lease status or its physical location.

In broad terms, this regime includes several tax incentives. Among others, we highlight:

- possible IMI exemption for urban property subject to rehabilitation, applicable for a period of three years, which may be renewed for a subsequent period of five years;
- possible IMT exemption for the acquisition of urban property considered a permanent place of residence destined for urban rehabilitation. It must be the first transaction of the building after the rehabilitation and the building must be located in an urban rehabilitation area; and
- income obtained by both individuals and corporate investors and derived from the units held in the referred funds is subject to the WHT rate of 10% for income tax purposes.

Several particularities apply in the case of tax-exempt entities and non-residents.

Value-added tax (VAT)

General

The current standard VAT rates are:

(i) 23% (on the mainland);

(ii) 22% (on the island of Madeira) and;

(iii) 18% (on the islands of the Azores).

In accordance with the Portuguese VAT code, operations subject to IMT are VAT-exempt. As a result, the transfer of property subject to IMT is, as a general rule, exempt from VAT. Although there are some exceptions, the leasing of property is also a VAT-exempt operation under the Portuguese VAT code.

As a general rule, services rendered connected to a property located in Portugal are subject to VAT herein.

Transfer of property/leasing (exemption waiver)

The general rule in Portugal is that the sale/leasing of property is VAT-exempt.

Nevertheless, in order to minimise the effects arising from this exemption, it is possible to waive the VAT exemption upon the fulfilment of several strict conditions.

In order to qualify for the exemption waiver, several strict conditions need to be met. According to the VAT-exemption waiver regime on real estate transactions, there are three main types of conditions that need to be met:

1. Conditions regarding the property & leasing agreement

- The property (land for construction, building, or autonomous unit of a building) is registered for tax purposes.
- The property is registered in the name of the owner or landlord, and it cannot be residential property.
- The sale or the lease agreement needs to cover the totally of the property unit.
- The property unit is allocated to the undertaking of VAT-able transactions, ie, those that give a right to deduct input VAT.
- In the specific case of lease agreements, the annual rent should amount to at least one-twenty-fifth (1/25) of the acquisition cost or construction cost of the property.

2. VAT status of the property

Once all conditions above are met, it is only possible to apply for the VAT-exemption waiver (charging VAT on the sale or lease agreement), if one of the following situations arises:

- In the first sale or letting following the construction of the property where it is possible to recover the total amount (or part) of the input VAT arising from the construction. In the first sale or letting upon major improvement works that increase the TRV of the property by more than 30%, when input VAT can still be recovered.
- In every subsequent sale or letting followed by a previous VAT transaction, when the property is still within the claw back period (in certain cases, VAT recovered may need to be paid back to the Government Revenue department, currently 20 years).

It is not possible to waive the VAT exemption in the case of subletting, except when the building is used for industrial purposes.

3. Status of the parties

Regarding seller/landlord and the acquirer/tenant, respectively, being VAT taxpayers, both parties need to:

- Have VAT-able revenue exceeding 80% of total turnover. This rule may exclude the possibility of a waiver in the case of insurance companies, banks and financial institutions, the State and municipalities in general, when using the property or letting of property.
- Having accounts prepared under local adopted accounting principles, as required by both personal and corporate income tax codes.

This means that entities that own property in Portugal which are considered non-resident without a PE in Portugal, are not able to apply for the VAT exemption waiver, and are therefore not able to recover any input VAT.

The VAT exemption waiver is requested on a transaction basis, in respect of each building/land sold or leased, through a request made by the seller/landlord to the Portuguese VAT administration on its internet website; and it has to be obtained prior to the signing of the sale or lease agreement.

Input VAT incurred with each operation or project, and with construction works, is deductible, from the moment the property is allocated to VAT-able operations, for a period of four years back from the date of each invoice issuance.

In the event of an acquisition of property, VAT will be self-assessed by the acquirer, meaning that VAT will be charged and deducted, if and when possible by the acquirer of the property.

Right to deduct input VAT

The VAT deduction regime in case of property activities is the allocation method, ie, deduction per distinct activity, which allows the deduction of VAT on a separate basis for each taxable and exempt activity which requires separate accounts per activity.

Regarding expenses that it is not possible to allocate to a specific activity, entities are entitled to deduct VAT on the proportion of the taxable operations carried out, based on a specific method of calculation (pro rata method).

Taxable persons are allowed to combine both VAT deduction regimes.

In the case of VAT exemption waiver, deduction of total input VAT can only be claimed after the acquisition agreement or the definitive leasing contract is signed (in both cases prior VAT exemption waiver certificates must be obtained).

VAT returns should be filed on a monthly or quarterly basis, depending on whether the annual turnover equals or exceeds 650,000 EUR, being delivered to the VAT administration by the tenth day of the second subsequent month after the month when the chargeable events occurred. Quarterly returns have to be filed with the Portuguese Tax Administration by the fifteenth day of the second month after the respective quarter calendar ends.

VAT recovery on property is subject to a VAT claw back during a period of 20 years (ten years for properties acquired before 13 February 2001), during which certain occurrences may require VAT adjustments. The right to VAT deduction is attributed, provided the property is allocated to a VAT-able activity. Any modifications to this situation in the course of the 20 (or ten)-year period since the occupation of the property require adjustments of VAT on behalf of the revenue.

Acquisition of a Portuguese property company

General

Companies or individuals wishing to invest in Portuguese real estate may acquire the shares in a company owning property, rather than make a direct purchase of the property.

Given the fact that the company may have a tax history and contingent liabilities, it is generally advisable to conduct a tax due diligence review of the target company. In such a due diligence, corporate tax, VAT and the transfer tax position of the company should be checked. If necessary, the seller of the company should be asked for certain guarantees on the tax position of the company.

Legal aspects

The most common vehicles for investment are the private limited liability company, (*sociedade por quotas,* or SQ), and joint-stock company (*sociedade anónima*, or SA).

Private limited liability company (SQ)

The transfer of quotas has to be executed by a written document and registered with the Commercial Registry Office. Consent from the company is required, except for transfers to other shareholders or family members of the transferor (spouse, ascendants, descendants) and unless the consent requirement is waived by the by-laws of the company or by means of a quota holder's agreement.

Joint-stock company (SA)

Shares may be registered in books (book entries) or represented by share certificates (also called certificated securities) depending on whether they are represented by registrations in an account or by paper documents.

Procedures for transfer of shares consist of a written declaration of the holder and a registry entry in the company's share registration book.

The articles of association may not exclude or limit the transferability of shares otherwise than as permitted by law.

Tax aspects

Corporate tax

Resident companies

If shares in the capital of a company owning property are acquired by another company, the latter company must value the shares in the acquired company at the acquisition cost.

Contrary to a direct purchase of property, the purchaser of the shares in a property company does not benefit from any step-up in the fiscal value of the property, since for corporate tax purposes, the company owning the property must continue to value the property at its original acquisition cost, even if booked at fair value. Hence, the fiscal value of the underlying property will remain the same, and the annual tax depreciation will be lower, compared to a direct purchase of property.

Dividends may be exempt from corporate income tax. Besides the subsidiary being subject to corporate tax, the following conditions (among others) should also be met:

- Holding level: the parent company must have a shareholding of at least 10%.

- Holding period: the respective shareholding must be held for one consecutive year before being entitled to the exemption, or, since the incorporation date of the subsidiary, if this period is shorter, providing the same one-year holding period is observed.

If the conditions above are not met, taxation will arise and WHT will apply. The corporate income tax withheld constitutes an advanced payment on account of the final tax due by the company receiving the dividend.

Capital gains (and capital losses) realised on the sale of shares are the difference between sales price and acquisition cost of the shares (updated by the official monetary devaluation index, applicable upon a minimum holding period of two years). Capital gains are exempt from CIT, as long as, among other conditions:

- The parent company must have a shareholding of at least 10%;
- The participation is held for at least one year;
- The subsidiary does not have more than 50% of its total assets in the form of real estate located in Portugal. In this case, for the computation of the percentage level it does not include real estate that is used as commercial activity, except for in case of buying and selling real estate activity.

In case the above mentioned conditions are not met, capital gains (and capital losses) realised on the sale of shares are part of the company's taxable income.

Non-resident companies

Dividends distributed by a resident-affiliated company to a non-resident parent company are subject to a 25% WHT (or 35% if distributed to a resident in a country, territory or region subject to a clearly more favourable tax regime, ie, a tax haven entity).

Under the application of the domestic participation exemption regime (that is applicable to both EU and non-EU residents and fully in line with the EU Parent-Subsidiary Directive), this 25% WHT rate can be eliminated where non-resident parent company, among other conditions, holds at least 10% of the share capital of the affiliated company resident in Portugal for at least one consecutive year, or, since the incorporation date of the subsidiary, if this period is shorter, providing the same one-year holding period is observed.

Where the minimum holding period of one consecutive year is not observed, provisional WHT under domestic law is levied. Such provisional WHT may be refundable when the minimum holding period of one year is achieved.

The WHT rate may also be reduced, usually to 15% or 10%, under the DTTs concluded by Portugal.

Capital gains arising from the sale of shares acquired before 1 January 2001 held in Portuguese resident property companies by non-resident companies are exempt in Portugal.

Capital gains arising from the sale of shares acquired on and after 1 January 2001 held in Portuguese resident companies, whose assets are comprised in more than 50% by property located in Portugal, by non-resident entities are subject to 25% CIT in Portugal. This tax may be avoided, depending on whether the non-resident entity is entitled to the protection of a DTT that does not give the right to Portugal to tax such capital gains.

Capital gains shall be liable to taxation in Portugal, whenever they result from the transfer of share capital or similar rights in any entity (non-resident in Portuguese territory), when, in any given time in the past 365 days, the value of those shares or rights result, directly or indirectly, in more than 50% of immovable property or rights in rem over immovable properties located in the Portuguese territory (except if related to agricultural, industrial and commercial activity and not the sale and purchase of immovable property).

Personal income tax

Resident individuals

Dividends are subject to a 28% WHT. It corresponds to the final taxation of such income, unless the individual opts to include the respective amount within their overall income, in which case the tax withheld corresponds to an advance payment of the final tax due under the marginal rates applicable to the total income, which vary between 14.5% and 48%, depending on the respective tax bracket. In addition, an additional solidarity rate of 2.5% on the taxable income between 80,000 EUR and 250,000 EUR and of 5% on taxable income exceeding 250,000 EUR may be due. In this case tax refunds are allowed.

Capital gains arising from the sale of shares, including the ones held in the share capital of property companies, are subject to taxation at the rate of 28%. Or, if the individual opts to add such capital gains to the remaining income, they will be subject to progressive tax rates. In this case, tax refunds are allowed.

The taxable gain is equal to the difference between the sales price and acquisition cost of the shares, (updated by the official monetary devaluation index, applicable upon a minimum holding period of two years). Expenses related with the purchase and sale can be deducted to the acquisition cost and to the sales price respectively.

Non-resident individuals

Dividends paid to non-resident individuals are subject to WHT at a standard rate of 28% (or 35%, if distributed to a resident in a country, territory or region subject to a clearly more favourable tax regime). The WHT rate may be reduced, usually to 15% or 10%, under the DTTs concluded by Portugal.

Capital gains arising from the sale of shares held by non-resident individuals in property companies resident in Portugal are taxed at a 28% flat rate. This taxation may be avoided, depending on whether the non-resident entity is entitled to the protection of a DTT that does not give the right to Portugal to tax such capital gains.

Property transfer tax (IMT)

In principle, the acquisition of shares in a company owning Portuguese property does not qualify as an acquisition of property itself; it remains, therefore, outside of the scope of this tax.

However, an exception to this principle applies in cases where shares representing 75% or more of total share capital of a Lda company, of a general partnership, or of a simple limited partnership, owning property are acquired (see section "*Investing in Portuguese property through a partnership*").

Value-added tax (VAT)

The acquisition of the shares in a company owning Portuguese property is not subject to VAT.

Investing in Portuguese property through a partnership

The term "partnership" may be misleading for investors from most countries, whose legal systems include similar types of business organisation, but according to which they are non-incorporated entities, ie, are not considered as legal entities separate from their partners.

In fact, under Portuguese company law, partnerships are incorporated, meaning they have a legal existence separate from the partners, with several consequences at different levels, eg, in the field of taxation, where the tax transparency regime is not automatically applicable on the grounds of the legal form adopted.

Investing in Portugal through a real estate investment fund

Under the Portuguese collective investment vehicles regime, it is possible to incorporate an investment vehicle either under contractual form (real estate investment fund, or REIF) or corporate form (*sociedade de investimento imobiliário*, or SIIMO, and the most recent *sociedade de investimento e gestão Imobiliária*, or REIT).

General

Whenever the investor is not interested in the management of the real estate asset and is only focused on the return that may come from the same, it may be considered the financial investments, that can be made through a REIF (investment vehicle incorporated under contractual form), a SIIMO and a REIT (investment vehicle incorporated under corporate form).

Real estate investment funds and the management company

The sole purpose of real estate investment funds established under Portuguese law is to invest, according to a shared risk principle, funds obtained from investors. Assets are separate and autonomous from the unit holders but are jointly owned by them. The fund is not a legal entity.

It is mandatory that they are managed by management companies, which must be incorporated as joint-stock companies (SA), with an effective head office in Portugal. Its statutory objective should mainly be to manage one or more funds for the account of the respective unit holders.

Types of real estate investment funds

These funds are divided into investment units and can either be:

(i) opened-ended, in which case the units are issued in a variable number; and

(ii) closed-ended, where the units are issued in a fixed number.

Regulatory aspects

The setting up of a real estate investment fund is subject to prior authorisation from the Portuguese Securities Market Commission (CMVM) upon request of the management company. CMVM is responsible for the supervision of the fund.

Qualifying assets

The qualifying assets to these funds are:

(i) urban properties or buildings divided into horizontal property regime (condominium regime) and rural/farmland;

(ii) investment units in funds;

(iii) cash instruments, such as bank deposits, certificates of deposits;

(iv) shareholdings in property companies under certain circumstances.

Taxation regime of real estate investment funds

Taxation at the real estate investment fund level

For CIT purposes, the taxable profit of real estate investment fund incorporated under Portuguese law corresponds to the net income of the period, computed in accordance with the applicable accounting standards. However, the following income/expenses, among others, are disregarded:

- investment income, rental income and capital gains (unless if derived from tax heaven entities);
- expenses related to the income referred above;
- income and expenses related to management fees and other commissions reverting to the fund.

The computed taxable income is subject to the main CIT rate (currently of 21%). The real estate investment fund is exempt from local and state surtaxes, being however subject to autonomous taxation foreseen in the CIT code for certain expenses.

Tax losses generated by the fund can be carried forward to offset taxable profits arising in the following five years. No carry back is allowed.

Deduction of tax losses brought forward is limited to 70% of the taxable profit of the year, with the possibility of carrying forward the remaining 30% within the carry forward period.

The real estate investment fund is also subject to stamp duty levied on its net asset value at a rate of 0.0125%. The stamp duty is assessed quarterly, in March, June, September and December of each year and should be paid before the 20th day of the month following the end of the quarter.

Property acquired/owned by the real estate investment funds that are set up and operate in accordance with the Portuguese law is fully subject to IMT, annual IMI, and stamp duty. Stamp duty is not levied when VAT is charged on the transaction.

Taxation at the unit holder level

The income obtained by resident investors or PEs in Portugal of non-resident investors is subject to taxation at personal income tax level (generally, at the rate of 28%) or at CIT level (being considered in the taxable profit of the investors, taxed at the CIT rate of 21%, plus municipal and state surtaxes, if applicable).

The income obtained by non-resident investors without PE is taxed at a 10% rate, including redemption and capital gains.

Different rules apply if the investor, among others:

(i) is domiciled in a tax haven; or

(ii) as a general rule, is directly or indirectly held in more than 25% by tax residents in Portugal.

For DTT purposes, distribution income and gains derived from the redemption and sale of units qualify as income from immovable real estate.

Property transfer tax (IMT)

As a general rule, the acquisition of units in a real estate investment fund is not subject to IMT. However, an exception to this rule applies to the acquisition of units of privately placed close ended real estate investment funds, as well as redemptions, capital increase and decrease operations, among others, when one of the unit holders, or two unit holders that are married or unmarried but sharing the same tax address, become the owners of at least 75% of the units of the fund.

Other real estate investment funds

Real estate urban rehabilitation investment funds

Real estate investment funds that:

- set up and operate in accordance with the Portuguese law between 1 January 2008 and 31 December 2013;
- whose assets are comprised of at least 75% by properties subject to urban rehabilitation; and
- such properties are located in certain specific areas

are fully exempt from corporate income tax on all types of income (including rental income and capital gains). These may also benefit from IMT and IMI exemption.

Real estate investment funds for residential letting

This type of real estate fund (*fundos de investimento imobiliário para arrendamento habitacional*, or FIIAH) set out according to the Portuguese legislation, between 1 January 2009 and 31 December of 2015, may benefit from several tax benefits until 2020. Some of these benefits are:

- corporate income tax exemption on all types of income;
- IMI exemption for properties that are part of the portfolio of the FIIAH; and
- property transfer tax exemption for acquisitions made under this regime by the FIIAH.

At unit holder level:

- personal and corporate income tax exemption on income distributed by the fund. This exemption does not apply to capital gains arising from the sale of such participation units.

Some tax benefits may also be applicable to individuals that sell their residential properties and subsequently sign a lease agreement for such property. Several conditions need to be met.

The above-referred tax regime and respective exemptions are not applicable to entities resident in a country or jurisdiction with a more favourable tax regime (listed tax havens).

Investing in Portugal through *sociedades de investimento imobiliário* (SIIMO)

General

The *sociedades de investimento imobiliário* (SIIMO) were introduced in June 2010. They are regulated investment vehicles for investing in real estate.

The SIIMO are collective investment schemes adopting the legal form of a joint-stock company (SA), which can either be a fixed capital company (SICAFI) or a variable capital company (SICAVI), whose assets are managed, on a fiduciary basis, on the sole interest of their shareholders. SIIMO can be internally managed or managed by an independent management company. Assets are entrusted to a depositary bank.

Regulatory aspects

There is regulatory supervision of the SIIMO, being the regulatory authority the CMVM. The management company, if any, is governed by the banking law, is supervised by the Bank of Portugal and is only allowed to manage regulated SIIMO.

Periodical financial reports are sent by the management company to the CMVM.

Taxation of SIIMO

As a general rule, SIIMOs are taxed under the same rules as apply for real estate investment funds for both income and property taxes.

Investing in Portugal through real estate investment trusts (SIGIs)

General

SIGIs were introduced in Portugal with effect from 1 February 2019, following similar REIT models implemented in Europe.

SIGIs, with tax residence and place of effective management in Portugal, are joint-stock companies (SA) with the minimum share capital of 5 million EUR. It is possible, upon decision of the general meeting, to convert already existing real estate companies into SIGIs.

SIGIs must have as main activity:

(i) acquisition of real estate, surface rights and/or other real estate rights for letting;

(ii) acquisition of shares in the capital of other SIGIs or companies resident in Portugal or in another EU Member State, EEA Member State, under certain conditions; or

(iii) acquisition of units or shares in CIV, specialised in residential letting, governed by Portuguese law having similar profit distribution rules.

SIGI's portfolio must be comprised by real estate and investments in real estate entities representing at least 80% of the total assets and by real estate let or allocated to other atypical contractual forms related to the granting of the use of space in properties, which may include the provision of services, representing at least 75% of the total assets.

Both real estate assets and shareholdings above-mentioned must be held for at least three years from their acquisition date. Additionally, SIGI's indebtedness cannot exceed, at any time, 60% of their total assets.

SIGIs must distribute 75% of their annual profits and 90% of their annual profits that derive from dividends and other income from shares held in real estate entities.

Regulatory aspects

SIGIs shares must be listed on a regulated market in Portugal, in another EU Member State or in an EEA Member State (which as committed to administrative cooperation in tax matters similar to those in the EU), within one year following its incorporation date.

SIGIs have a free float requirement of 20% from the end of the third year after their admission and from the fifth year onwards, this requirement increases to 25%.

Taxation of SIGIs

SIGIs are subject to the same tax regime as the one applicable to regulated real estate investment vehicles.

Financing the acquisition of Portuguese property

Legal aspects

Minimum share capital

One of the main differences between a private limited liability company (SQ) and a joint-stock company (SA) is the minimum share capital required for their incorporation.

For a SA, the requirement is 50,000 EUR and the payment of 70% of the contributions to be made in cash may be deferred. For a SQ, the requirement is 1 EUR per each quota and a minimum of 2 quotas.

Minimum debt/equity ratio

Pursuant to Article 35 of the Companies Code, when it results from the company's accounting that half of the share capital has been lost, the directors must immediately convene a General Assembly to inform the remaining shareholders of this situation.

The agenda for the General Assembly must contain three specific topics: (i) dissolution of the company; (ii) share capital reduction to an amount no lower than the company's equity; and (iii) equity increase made by the shareholders.

Mortgage and other guarantees

Mortgages are the most common type of collateral, which guarantees the payment of a specific credit. It can be voluntary or legal, depending on the reason for its creation. For example, bank mortgages for the purpose of granting loans are voluntary mortgages and mortgages for the guarantee of a specific debt to a public entity (such as the Social Security or the Tax Authority) are legal mortgages.

It should be stressed out that the registration of mortgages with the Land Registry Office is essential for the validity and enforceability of the guarantee.

Portuguese law contemplates a special procedure for mortgage foreclosure. Preferentially, property will be subject to a sale through electronic auction. If this regime is frustrated, then property will be sold through sealed bidding procedure and the highest bidder will, generally, become the new owner.

Tax aspects

Equity financing

Under Portuguese tax law, subscription and paying in of statutory share capital at incorporation as well as subsequent increases are not subject to stamp duty.

Registry fees, as well as other related expenses (eg, contractual expenses), are due on this type of operation.

If the contributions of the shareholders are made in kind by means of a transfer of property to the company, property transfer tax, or IMT, will be levied under general rules (see section "*Direct investments in Portuguese property*/*Property taxes*").

Debt financing

Deductibility of interest

The general principle regarding the acceptance of costs and expenditures as tax-deductible expense is that these are necessary to assure or obtain income subject to taxation.

To this extent, interest and other financial expenses arising from related parties' transactions are, in principle, tax-deductible, provided they are established at "arm's length".

Under the net financial expense's capping rule, their deductibility is limited to up to the higher of:

(i) a fixed cap: 1 million EUR; or

(ii) a variable cap: 30% of the fiscal EBITDA (which corresponds to the taxable profit or tax loss of the year, plus any net financial expenses and allowed depreciation and amortisation).

WHT on interest

Resident entities

Interest received by Portuguese resident companies, arising from loans and paid by an entity taxable in Portugal, are subject to a 25% WHT, which assumes the nature of an advance payment of the final tax due.

No WHT applies, in case of shareholders loans when the shareholder holds at least 10% shareholding for a consecutive year before interest are made available.

Interest received by resident individuals, arising from loans and paid by an entity taxable in Portugal, is subject to 28% WHT and can be regarded as final tax.

Non-resident entities

Interest received by non-resident companies, arising from loans and paid by an entity taxable in Portugal, are taxed at the 25% (or 35% if due to a resident in a country, territory or region subject to a clearly more favourable tax regime) flat WHT rate, in cases where the entity receiving the interest is resident in a country that has not signed a DTT with Portugal.

Under the Interest-Royalty Directive, no WHT may be levied. The minimum shareholding level and holding period required are 25% and two years respectively. The definition of associated company is in line with the one set out in the Directive.

In case of non-resident individuals, interest arising from loans and paid by an entity taxable in Portugal, are taxed at a 28%.

Interest paid or made available to accounts opened in the name of one or more holders acting on behalf of one or more unidentified third parties is subject to the final WHT rate of 35%, unless the beneficial owner of the income is identified.

Where the beneficiary is resident in a country that has concluded a DTT with Portugal, the WHT rate may be reduced, in most cases to 10% and 15%.

Indirect taxes (stamp duty)

Stamp duty is levied at different rates on different aspects/components of financing operations. In this respect, it is important to distinguish between those concluded with banks or other credit institutions, and those established with the company's shareholders.

In the former case, stamp duty applies as follows:

- principal lent or capital guaranteed, depending on the maturity, at 0.04% per month for funding up to one year, at 0.5% for funding with maturity varying from one year to less than five years, and 0.6% for five or more years.
- commissions on guarantees, at 3%.
- interest, commissions and other fees charged by banks or financial institutions, at 4%.

Shareholders' loans may also be subject to stamp duty, although several exemptions are available, depending on the specific terms and conditions of the transaction.

Real estate financial lease

Financial lease agreements (*contrato de locação financeira*) are legally defined as the agreements whereby one party (financial lessor) undertakes, in return of retribution, to assign to the other party (financial lessee) the temporary use of a thing, that may be of movable or immovable nature, acquired or built as per request of the financial lessee, and which the latter may purchase, after the agreed period, for a price to be determined or determinable by simple application of the criteria set forth in the financial lease agreement,

As per real estate assets, although the financial lease agreement may be entered into by means of a private document, the signatures must be dully recognised. Also, the construction/use permit of the real estate asset must be certified alongside with the signatures.

Once the financial lease agreement term elapses, the financial lessee has three options:

(i) exercise the purchase option of the real estate asset for a certain amount;

(ii) return the real estate asset to the financial lessor; or

(iii) renew the agreement for another period of time.

Transferring real estate

According to the Land Registry Code, every act which modifies the ownership of a certain real estate property must be registered before the Land Registry Office. Also, every transfer of property must meet all requirements established in the Portuguese Civil Code.

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Real Estate Going Global

Romania

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

The principle of free transferability of assets is enshrined in the Romanian law, with only few restrictions on the acquisition of real estate or a set of conditions to be met to this effect (eg, restrictions for non-EU foreign companies and individuals; the pre-emption right of the persons/state regarding certain property with special statute, etc).

Romanian individuals and legal entities (regardless of the citizenship of the shareholders) are free to acquire land.

Foreign citizens, stateless persons and legal entities may acquire land ownership in Romania only under certain circumstances. European nationals, part of the EU or EEA, may freely acquire construction and agricultural land in Romania. Foreign nationals outside the EU and the EEA will be able to acquire ownership in compliance with international treaties.

Taxation of income obtained from transfer of real estate, from sale of shares or direct investments

The income from the transfer of real estate is taxed differently depending on the period of ownership and the value of the real estate.

Capital gains from sale of shares obtained by legal persons are taxed in Romania at 16%, unless the participation exemption regime applies, whereby more than 10% of the shares are held for more than one uninterrupted year at disposal date. As from 1 January 2018, according to the provisions of the Fiscal Code, individuals who realise income from the transfer of securities (shares, fund units owned by investment funds) owe income tax of 10% of their gains (the rate was 16% before the amendments).

Foreign individuals are generally subject to the same tax treatment as Romanian individuals, but depending on the fiscal residence of the individual, treaty relief may be available. As from 2018, capital gains obtained by individuals are also subject to individual health contribution (10%) if the income exceeds a certain threshold (12 minimum gross salaries per year, currently equal to 26,760 Romanian lei (RON) per year).

In the event of a direct investment, under Romanian law, any profit (including capital gains) related to Romanian real estate earned by a non-resident company is subject to 16% profit tax. Under most of the currently applicable double tax treaties concluded by Romania, capital gains obtained by non-residents from real estate property located in Romania are generally taxable in Romania. Ownership of real estate does not necessarily constitute a permanent establishment (PE) in Romania.

Rental income

If the landlord is an individual, the net rental income (ie, after deemed expenses deduction of 40%) is subject to individual income tax at the flat rate of 10%. From 1 January 2018, rental income is also subject to individual health contribution of 10% if the total personal yearly income (excluding salary income) exceeds a certain threshold (12 minimum gross salaries per year, currently equal to 26,760 RON per year).

If the landlord is a company, the net rental income is taxed at 16% profit tax. Expenses incurred that are directly related to deriving the rental income are generally tax-deductible from the taxable revenue as a whole, although there are some special rules that might make some expenses non-deductible.

Depreciation

The depreciation method to be used for buildings is the straight-line method. Other methods, such as the accelerated depreciation or reducing balance methods, are not applicable for buildings.

Property taxes

Building tax

According to the Romanian Fiscal Code, buildings are classified based on their utilisation purposes as follows:

- residential buildings, which are used strictly for residential purposes;
- non-residential buildings, which are used for economic purposes;
- mixed-purpose buildings, ie, those used for both residential and non-residential purposes.

In case of residential buildings owned by individuals and legal entities, the building tax is calculated by applying a rate ranging from 0.08% to 0.2%, to the taxable value of the building. In case of non-residential buildings owned by individuals and legal entities, the building tax is calculated by applying a rate ranging from 0.2% to 1.3% to the tax value of the building. In case of mixed usage, if the building address is registered as a fiscal residence (eg, for an individual or for a company) but at which no economic activity is performed, the tax is calculated according to the regulations applicable to the residential buildings. Where there is mixed usage with actual economic activity, the building tax is determined proportionally. There are also other rules concerning mixed usage.

In case of non-residential buildings, there is an obligation to perform a valuation (every three years for legal entities or every five years for individuals). The valuation should be performed by an independent Romanian valuator according to a specific valuation standard. If this requirement is not met, the building tax rate may be increased to 2% (for individuals) or even 5% (for legal entities).

The tax on buildings is due for the entire fiscal year (FY) by the person who owns those assets at 31 December of the previous fiscal year, irrespective of whether these assets are alienated during the reference year.

Building tax is paid twice a year, by 31 March and 30 September, in equal instalments. As a rule, if the building tax due for the entire year is paid in advance by 31 March, a reduction of up to 10% may be granted by the Local Council.

Land tax

Owners of land are subject to land tax established at a fixed amount per square metre, depending on the rank of the locality where the land is located and the area or category of land use, in accordance with the classification made by the Local Council.

The provision according to which for the surface of land, which is covered by a building, the tax land is not due was eliminated.

Likewise, the tax on lands is due for the entire fiscal year by the person who owns those assets at 31 December of the previous fiscal year, irrespective of whether these assets are alienated during the reference year.

Similar to building tax, land tax is paid twice a year, in equal instalments, by 31 March and 30 September. A 10% reduction is granted for full advance payment of this tax by 31 March.

Real Estate Investments

Legal framework

Acquiring title to real estate in Romania

The principle of free transferability of assets, with the owner being free to dispose of property, is enshrined in Romanian law. The applicable law prescribes a few restrictions on the acquisition of real estate or a set of conditions to be met to this effect, for instance, the duty to observe inter alia:

- the pre-emption right of the state if selling property qualified as a historical monument;
- the pre-emption right of the state if selling woodland;
- the pre-emption right of the dispossessed owner to the purchase of their expropriated real estate when the scope of the dispossession was not fulfilled;
- the pre-emption right of the lessee for the nationalised houses before 1990, which are not resituated back to the former owners, etc;
- the pre-emption right of the (i) co-owners and relatives, (ii) owners/lessees of specialised investors for trees, vineyard etc, and agricultural lessees (iii) lessees or owners of neighbouring land, (iv) young farmers, (v) agricultural state entities (vi) individuals residing in the same locality were the land is located (viii) Romanian state - for agricultural land located outside the buildable area of the municipality; and
- other conditions expressly provided by law.

Romanian and European nationals (nationals of the European Union and/or of the European Economic Area), natural persons and legal entities (regardless of the citizenship of the shareholders) are free to acquire land in Romania under the same conditions are Romanian citizens.

Non-EU/EEA citizens and entities are allowed to acquire land ownership in Romania, only under international treaties executed by the Romanian State and on reciprocity basis.

Non-EU/EEA individuals or companies may own buildings and may acquire the right to use land (based on lease agreements, concession agreements, etc).

Notarisation and registration of title to real estate

Romanian law requires the notarisation of any transfer agreement regarding ownership of land or house located in Romania. Notarisation is compulsory for the validity of the ownership transfer.

The ownership transfer has to be recorded in the Real Estate Register (Land Register) in order to be effective against third parties. However, in some parts of Romania, the registration of ownership in the Real Estate Register has only recently been implemented and, therefore, it may be difficult to verify ownership when purchasing real estate property. It is advisable to conduct legal title checks on any property prior to acquiring it.

On 1 October 2011, Romania adopted a new Civil Code, which stipulates that the registration with the Land Register is made for the validity of the ownership transfer and not only for ensuring its effectiveness against third parties. However, said provisions will only enter into force after the full cadastral mapping of real estates in Romania is completed.

The National Cadastre and Land Registration Agency regulates the real estate property registration in Romania, a role taken over from the Ministry of Justice. This Agency also coordinates and oversees the performance of cadastral work at the national level.

Ownership and other real rights to an immovable asset are to be entered in the real estate information register (ie, Land Register), solely on the basis of deeds creating or transferring rights in rem, which have to be concluded with the observance of the authentic (notarised) form.

Upon authentication of an instrument establishing, modifying or extinguishing a legally enforceable right in property, the notary public requests a Land Register abstract for authentication. For the valid conclusion of a transferring deed of ownership, the owner is obliged to present the notary public with a fiscal certificate attesting that there are not any outstanding taxes related to the respective property. During the term of validity of the abstract for authentication, the Real Estate Registry may only register the transaction for which the abstract was issued.

After the public notary has prepared the deed of conveyance, which alters, establishes or extinguishes a legally enforceable right in real estate, the notary registers the operation with the Land Register.

Time-sharing legislation

The Government Emergency Ordinance that transposes Directive 2008/122/CE of the European Parliament and of the Council on the protection of consumers in respect of certain aspects of timeshare, long-term holiday product, and “resale and exchange contracts” has also taken effect starting from 23 February 2011.

Mortgaging real estate

Mortgages are created under authentic deeds and must be recorded in the Land Register to have an effect towards third parties.

Mortgages are created only over land/buildings as a whole or over the share owned by any of the co-owners. The creation of mortgages over a future asset is subject to compliance with specific regulations regarding mortgage credit for real estate investments, based on the prior registration with the Land Register of the building permit and the partial delivery and acceptance minutes.

In order to foreclose on the mortgage, the mortgagee (eg, a bank) must resort to a bailiff to start the foreclosure procedure. Commencement of this procedure is registered in the Land Register. Objections can be filed against the foreclosure procedure in front of a competent court, which may suspend the foreclosure procedure based on a specific request to this effect.

In the event of bankruptcy, the mortgagee submits its claim to the liquidator and has priority in the sale proceedings of the asset mortgaged over any other receivables, except for the taxes, stamps and other liquidation costs relating to the sale of the asset.

Public–Private Partnership (PPP) legislation

The PPP legislation includes Government Ordinance No 39/2018 on public-private partnership, and, in a broader view, also Law No 98/2016 on public procurement, Law No 99/2016 on sectors services procurement and Law No 100/2016 on concessions of goods and services.

Taxation

General

The main provisions of the Fiscal Code relating to real estate are set out below. The current definition of real estate property refers to land, buildings or constructions built or incorporated into a land area.

Taxation of investments through a Romanian company

On the sale of real estate by a local company the capital gain is included in the taxable profit of the company, subject to 16% profit tax (if in an overall profit position). Capital losses on sale of real estate may be offset against regular profits of that company.

The sale of shares in a Romanian company by another Romanian company is also subject to 16% profit tax, unless more than 10% of the shares are held for more than one uninterrupted year at disposal date. If the shares in a company are sold by a non-resident corporate shareholder, they are also generally subject to tax at 16%, with the exception of cases where more than 10% of the shares are held for more than one year. In order for such exemption to apply, a double tax treaty should exist with the jurisdiction of the non-resident corporate shareholder.

Capital gains obtained by non-residents from the sale of shares held in a Romanian company are also taxable in Romania. However, participation exemption applies for capital gains derived by a non-resident legal entity from participations of at least 10%, held for a minimum period of one year, in a Romanian company, provided there is a double tax treaty in place between Romania and the country od residence of the seller. Also, the income may be subject to treaty protection.

Taxation of income obtained from transfer of real estate by Romanian and/or non-resident individuals

Transfers of Romanian real estate property are subject to transfer tax. The tax transfer is calculated according to the sale price. The Fiscal Code provides a tax of 3% on taxable income. Taxable income is determined by deducting from the transaction value the non-taxable amount of 450,000 RON (approx. 92,000 EUR). The tax is calculated and charged by a public notary. The seller is liable for the payment of the tax.

No income tax is due for ownership over estates acquired under special laws, for donations between third-degree relatives, donations between spouses, and for inheritances, provided the procedure is finalised within two years (income tax of 1% is levied if the succession procedure is not completed within those two years).

Income tax due for transfer of ownership is calculated at the value declared by the parties in the transfer documents and withheld by the public notary. If the value declared by the parties is lower than the minimum value established through market research conducted by the Chamber of Notaries Public, the public notary notifies the transaction to tax authorities. The tax remittance deadline is the 25th of the month following the month in which the income was withheld.

Taxation of sale of shares in the case of Romanian and/or non-resident individuals

Capital gains obtained by individuals from sale of shares are taxed in Romania at 10%.

The obligation of calculating and paying the income tax from the transfer of securities lies with the taxpayer. As from 2018, income obtained by individuals is also subject to individual health contribution (10%) if the total personal yearly income (excluding salary income) exceeds a certain threshold (12 minimum gross salaries per year, which amount currently to 26,760 RON per year).

Any net loss resulting from the transfer of securities, other than shares and transferable securities in non-listed companies can be carried forward for up to seven consecutive tax years.

Foreign individuals are generally subject to the same tax treatment as Romanian individuals. However, based on the fiscal residence of the individual, treaty relief may be available. Depending on the details of the transaction, the taxpayer has the obligation to compute, withhold and pay the capital gains tax from sale of shares. To fulfil this requirement, non-residents may appoint a Romanian fiscal representative or a tax agent.

Direct investment by foreign companies

In the event of a direct investment, under Romanian law, any profit (including capital gains) related to Romanian real estate earned by a non-resident company is subject to 16% profit tax. Under most of the currently applicable double tax treaties concluded by Romania, capital gains obtained by non-residents from real estate property located in Romania are generally taxable in Romania. Ownership of real estate does not necessarily constitute a PE in Romania, however, a case-by-case analysis should be undertaken.

Generally, all Romanian companies are subject to quarterly profit tax payments, with annual offset. Most companies (including those investing in real estate) may opt for a prepayment tax system (quarterly prepayments made, based on last year's profit tax adjusted by the inflation rate). However, in case of foreign companies, income from sale of shares and real estate located in Romania will be due by the 25th of the month following the quarter in which the transaction took place.

Foreign legal persons are required to submit annual profit tax returns, even if the profits is exempt from tax in Romania under the more favourable provisions of eligible double tax treaty. They may appoint a tax agent for meeting the above requirements for payment of profit tax and the submission of tax returns.

Taxation of rental income

Individuals

If the landlord is an individual, the net rental income (ie, after a deemed expenses deduction of 40%) is subject to individual income tax at the flat rate of 10%. As from 1 January 2018, rental income is also subject to individual health contribution of 10% if the total personal yearly income (excluding salary income) exceeds a certain threshold (12 minimum gross salaries per year, which currently amount to 26,760 RON per year).

Individuals who derive income from more than five rental contracts in one year are obliged for the next fiscal year to treat such income as income from independent activities and pay income tax accordingly.

Individuals who earn rental income are required to submit the Romanian annual single return for the purpose of estimating the rental income within 30 days of the conclusion of the rental contract.

Companies

If the landlord is a company, the net rental income is taxed at 16% profit tax. Expenses incurred that are directly related to the obtainment of the rental income are generally tax-deductible from the taxable revenue as a whole, although there are some special rules that might make some expenses non-deductible. In their Articles of Association, companies should have “rental activity” listed as their object of business in order to let real estate property.

Depreciation

The depreciation method to be used for buildings is the straight-line method. Other methods, such as the accelerated depreciation or reducing balance methods, are not applicable for buildings.

The Official Fixed Assets Catalogue, published under government decision, states the useful lives to be used for tax purposes. Ranges are provided for classes of fixed assets, from which the taxpayer can choose the useful life. The depreciation rates applicable to buildings vary according to the type of building. For office buildings, the depreciation period is between 40 and 60 years, while for other commercial buildings the depreciation period is between 32 and 48 years. Improvements made to buildings by the owner will generally follow the depreciation period of the building. Improvements in a leasehold property are generally depreciable over the remaining contractual period. It is possible to identify various components of the building, which can be depreciated separately.

Accounting revaluations are considered when computing the depreciable amount of fixed assets.

Land is not subject to depreciation.

Leasing provisions

Instead of a rental agreement, buildings could be leased either on a financial or operational lease basis.

A financial leasing contract is any leasing contract that meets at least one of the following conditions: the risks and benefits of the ownership over the goods subject to leasing are transferred to the user upon commencement of the leasing contract; the leasing contract explicitly provides for the transfer of ownership over the goods subject to leasing to the user upon expiry of the contract; the user has an option to buy the goods subject to leasing upon expiry of the contract and the ratio between the residual value and the principal is less than or equal to the ratio between the normal maximum useful life, minus the leasing period, and the normal maximum useful life; the leasing period exceeds 80% of the normal useful life of the goods subject to leasing (for the purposes of this definition, the leasing period includes any period for which the leasing contract may be extended); the total value of the leasing rates, ancillary expenses excluded, is higher than or equal to the entry value.

An operational leasing contract is any leasing contract concluded between the lessee and the lessor who transfers to the lessee the risks and benefits related to the ownership over the leased goods except for the risk of selling the goods at their residual value, and which does not fulfil the conditions of financial leasing. The risk of selling the goods at their residual value occurs when the purchase option is not exercised upon commencement of the agreement or when the agreement expressly provides for the return of the goods.

Under financial leasing, the lessee (user) is treated from a tax perspective as the owner, whereas under operational leasing it is the lessor that is treated as such. The depreciation of assets that are the object of a lease agreement may be made by the lessee, under financial leasing, or by the lessor, under operational leasing. With financial leasing, the lessee deducts interest, and with operational leasing, the lessee deducts rent (leasing instalment).

Revaluation of fixed assets

Companies are allowed to revalue their fixed assets at the end of each year, according to their own accounting policies. As from 1 May 2009, the step-up in value is not effective for tax purposes when calculating depreciation expense. The same principle applies when the building is sold or written-off. So, there is no longer a tax benefit for revaluations. This rule applies for all revaluations performed after 1 January 2004.

Companies need to keep separate records to reflect the distinct computation of the fiscal and the accounting regulations.

Loss carryforward

Fiscal losses can be carried forward for seven consecutive years (starting with losses incurred in financial year 2009).

Limitations on tax deduction of financing costs

Starting 1 January 2018, there is no distinction anymore between the tax regime of intra-group or bank financing, irrespective of the company capitalisation or its debt to equity ratio, since the tax deduction rule has been normalised for all investors and all financing sources. Briefly, an "excess borrowing costs" rule applies currently to Romanian legal entities, which means that a company that seeks financing solutions for either investment purposes, working capital needs or finance hedge will deduct only 1 million EUR plus 30% of a tax-adjusted EBITDA (for FY 2018, the threshold was 200,000 EUR plus 10% of a tax-adjusted EBITDA). The non-deductible excess borrowing cost is carried forward and may be deducted in subsequent years (subject to applying the same cap annually). The excess borrowing costs include net interest expenses and net foreign exchange losses. The non-deductible exceeding borrowing costs can be carried forward indefinitely. The calculation base is determined as the gross accounting profit, minus non-taxable revenues, plus exceeding borrowing costs and deductible tax depreciation.

The above-mentioned interest deductibility rules also apply to financial institutions, but not to independent entities (ie, entities that are not part of a consolidated group for financial accounting purposes and do not have related parties and PEs), which can fully deduct exceeding borrowing costs.

Equally important is that the above cap also affects all historical interest and net foreign exchange losses, which have accrued and were not deducted during development stages. Deduction of these costs may be postponed indefinitely or taken in immaterial amounts annually, depending on the company profitability.

Consequently, all real estate vehicles that become operational further to the investment stage or that undergo group buy-outs should update their medium to long-term budget simulations and consider their financing mechanisms or capital structures, to make sure that their deferred tax asset may be realised. Such tax costs may translate in higher cost of debt related to either inter-company, external bank lending or private equity funds.

Turnover tax

All newly set up companies and companies in Romania with a turnover less than 1 million RON as at the end of the previous year will automatically pay turnover tax of either 1% (if there is at least one employee) or otherwise 3% on their revenues. Once the threshold is exceeded, such companies become profit taxpayers and pay the regular 16% profit tax.

The implication for real estate special purpose vehicles is that development costs registered as expenses in the initial development period can no longer be carried forward and offset against future taxable profits.

Starting 1 April 2018, companies are allowed to opt out of the turnover tax regime once, based on certain criteria (minimum share capital of 45,000 RON and at least two employees).

Value-added tax (VAT)

Real estate operations

VAT treatment

Under the current Romanian VAT law, rental/leasing of real estate property is deemed as a VAT exempt operation without deduction right. However, the landlord/lessor has the option to apply VAT for any such operations, by way of submitting a notification for taxation to the tax authorities.

The Romanian VAT legislation provides, as a rule, that the sales of plots of non-buildable land, based on the town planning certificate and of buildings qualifying as old from a VAT perspective are subject to the VAT exemption without deduction right. However, the owner has the option to apply the taxation regime for these types of transactions, by way of submitting a notification for taxation to the tax authorities in this respect.

The supply of plots of building land, based on the town planning certificate, or buildings qualifying as new from a VAT perspective is subject to the taxation regime, as follows:

- Reduced VAT rate of 5% – for supplies of dwellings and houses delivered as part of social policy, including old people's homes, retirement homes, orphanages and rehabilitation centres for children with disabilities. This

category also includes dwellings and parts thereof supplied as housing with a maximum useful surface of 120 square metres, excluding outbuildings. The reduced rate applies if the value of the house acquired by any single person or family is less than 450,000 RON excluding VAT.

- Taxation under the reverse charge mechanism – for supplies of plots of building land or new buildings, if both, the purchaser and supplier, are registered for VAT purposes in Romania. More specifically, under this scenario, the supplier has the obligation to issue invoices without VAT, while the beneficiary will have to account for VAT under the reverse charge mechanism.
- Standard VAT rate of 19% – for supplies of plots of building land or new buildings, in case the conditions for the application of either the reduced VAT rate or reverse charge mechanism are not fulfilled.

From a VAT perspective, a building (or parts thereof) qualifies as new, if it is sold by the end of the year following its first usage/occupation. A construction that has been transformed, whereby the value of the transformation exceeds 50% of the building's value after transformation, is also considered a new building. Building land represents any unimproved/improved land on which constructions can be erected on, according to the town planning certificate.

The supply of land on which a building is erected, but where a demolition process is in progress, would be treated from a VAT perspective as a sale of land.

VAT deduction right

Any taxable person registered for VAT purposes in Romania has the right to deduct the VAT related to its acquisitions, if the goods/ services are purchased for the purposes of performing taxable transactions.

Taxable persons performing acquisitions related to the construction of real estate envisaged to be used for performing operations both with and without deduction right will be able to fully deduct the input VAT during the investment process. Nevertheless, depending on the actual use of the investments with respect to the construction of real estate, the deducted input VAT has to be adjusted accordingly.

The VAT deduction right is also granted for the acquisitions of immovable assets performed from taxpayers within the enforcement procedure and/or from taxable persons that undergoing the bankruptcy procedure, provided that the supply is taxable by law.

Input VAT adjustment for real estate assets

Where the landlord/ lessor does not opt to tax the rental fees/ lease instalments, while input VAT was deducted on acquisition/ construction of the real estate property, VAT should be adjusted annually within the adjustment period for 1/20 of the VAT costs incurred on the acquisition, manufacture or construction of those goods.

If the real estate property is sold within the VAT exemption regime, while VAT was deducted upon acquisition/ construction, the input VAT should be adjusted one-off for a period of 20 years for the remaining adjustment period.

The adjustment should be performed in accordance with the percentage of the real estate property rented/ leased/ sold within the VAT exempt regime, insofar as such transactions are performed within the 20 years adjustment period.

The VAT adjustment should be performed in the period the event that generates the adjustment occurs or in the last fiscal period of each year.

VAT transfer of business

The partial or total transfer of assets performed during a spin-off or merger is outside the scope of VAT if the beneficiary is a taxable person established in Romania.

Under certain conditions, also the partial or total transfer of assets performed to a Romanian established company through a sale or contribution in kind qualifies as a VAT neutral transfer of business. Specifically, the operation is seen as a transfer of business if the transferred assets form, from a technical point of view, an independent structure capable of carrying out economic activities. Also, the beneficiary must continue the economic activity which was transferred to him and not immediately liquidate it or sell the assets which were transferred to him. In this respect, the beneficiary must provide the transferor with a statement on own responsibility attesting that this latter condition is met.

In addition, the beneficiary is regarded as the assignor' successor for purposes of adjustment of the VAT deduction right.

In case the taxation regime is applied for transfer of business, the tax authorities will allow the VAT deduction if the taxation regime was not applied for tax optimisation reasons.

Import of equipment

VAT on imported goods is paid in customs, except for imports made by taxable persons registered for VAT purposes that obtained an import VAT deferment certificate from the customs authorities. In the latter situation, the VAT is not paid in customs, but is registered in the VAT return as both, input and output VAT. The threshold regarding the minimum value of imports for obtaining the VAT deferment certificate is 100 million RON in the last 12 consecutive months or in the previous calendar year.

In addition, the import VAT deferment certificate can also be obtained by companies with the status of Approved Economic Operator (AEO) and those authorised to perform in-house customs clearance formalities.

VAT refund

Established businesses in Romania

Although, based on the Romanian legislation VAT recovery should be made within 45 days of the date of filing the VAT return or 90 days from their submission (in case the resolution of the application requires a tax inspection), in practice the VAT refund process is a lengthy procedure (especially in Bucharest), subject to a prior tax inspection. The company can benefit from a fast VAT refund, if it achieves a low score in the risk analysis performed by the tax authorities.

The VAT receivables could be offset against other payable taxes and social contributions due by the company or could be assigned to another taxpayer. Please note that large and medium-sized taxpayers, as well as certain companies performing exports, can benefit from a VAT refund with a subsequent fiscal inspection, except for the cases where a high fiscal risk is assessed by the tax authorities.

Non-Romanian businesses

A company established in another EU Member State could claim a refund from the Romanian tax authorities of the VAT paid for goods/ services acquired in Romania, based on the 9th EU Directive (VAT refund for taxable persons established in the EU). The VAT refund is granted under certain conditions and if the operations performed by the company in Romania do not entail a VAT registration requirement or a fixed establishment of the company in Romania.

In addition, Romania implemented the refund procedure based on the 13th EU Directive for VAT related to purchases made in Romania by non-EU established businesses under reciprocity conditions. In principle, a non-EU business will be entitled to benefit from a VAT refund, under the 13th EU Directive, for the VAT paid on goods/ services purchased in Romania, if its operations herein do not entail a VAT registration requirement or a fixed establishment in Romania.

Withholding tax (WHT)

The 16% WHT rate generally applies on certain income sourced from Romania by non-resident companies, such as interest, commissions, services performed in Romania, management and consulting services (irrespective of where they are performed), etc.

According to the new provisions, the tax rate applicable for dividends derived by non-residents from Romania is reduced from 16% to 5%. The new tax rate is applicable to dividend income distributed starting on 1 January 2016.

The EU Parent-Subsidiary Directive is applicable to dividends distributed by Romanian companies to other Romanian companies or companies that are resident in other EU Member States (holding for more than one year at least 10% of the share capital of the Romanian company distributing the dividends). This implies that dividend distributions to qualifying shareholders are no longer subject to dividend WHT.

The EU Interest and Royalties Directive is also applicable so that no WHT may be levied for interest and royalty payments made between related parties, provided the conditions of at least 25% direct association and a two-year holding period are met.

The aforementioned domestic WHT rates can be reduced by double tax treaties provided the beneficiary of the payment makes a fiscal residence certificate available, its copy or any other document attesting to its tax residency, as well as a statement that it is the beneficial owner of the income (the latter applies to dividends, interest and royalty payments).

Other taxes and requirements

Other potentially material taxes and charges are due on the construction of buildings, as well as on the transfer of land from one designated category of usage to another. Reference is made to the separate section on local taxes.

Notary and cadastral fees

Notary fees are applicable on the transfer of real estate property, depending on the value of the transaction.

On 22 February 2011, Order No 46/C/2011 regarding the notary public fees came into force. Based on its provisions, the notary public fee for authenticating the sale and purchase agreement of a real estate is computed as follows:

Value of the transaction (in RON)	Amount of the fees (in RON)
<15,000	2.2% but no less than 150
15,001 to 30,000	330 + 1.6% for the amount exceeding 15,001
30,001 to 60,000	580 + 1.3% for the amount exceeding 30,001
60,001 to 300,000	970 + 0.9% for the amount exceeding 60,001
300,001 to 600,000	3,130 + 0.65% for the amount exceeding 300,001
600,001 or more	5,080 + 0.44% for the amount exceeding 600,001

However, certain discounts may be applied in specific cases expressly regulated by law.

A fee would also be due to the National Agency for Cadastre and Land Registration for changing the owner of 0.5% of the value of the agreement in case the buyer is a company and 0.15% in case the buyer is an individual.

Accounting requirements for Romanian companies

Accounting Law No 82/1991 (last republished in 2008) governs general accounting for Romanian companies. Legal companies, other than credit institutions, insurance companies and entities regulated by National Securities Commission, apply the Order No 1802/2014 approving Accounting Regulations regarding the individual annual financial statements and the consolidated annual financial statements.

Order No 1802/2014 is in compliance with the 4th and 7th EU Directives.

Municipal tax system in Romania

Local taxes are established by the Fiscal Code. The local authorities are allowed to adjust local taxes annually.

Local/county councils and the General Council of the Municipality of Bucharest are allowed to set the tax rate a maximum of 50% in excess of the ranges provided by the Fiscal Code on an annual basis.

For agricultural land uncultivated for two consecutive years, as well as for untidy urban buildings and land, the local council may increase the land tax or the building tax up to 500%, in accordance with the conditions established by the decision of the local council.

The tax is adjusted annually with the inflation rate, until 30 April of the year in question and not once in three years, as it was previously performed.

Late-payment interest accrues at 1% of the amount past due, calculated for each month or part thereof.

Building tax

Owners of buildings should pay building tax, except for cases where an exemption applies. The building tax rate is established by the local authorities with distinctions made between residential and non-residential destination.

For residential buildings owned by individuals or legal entities, the tax is computed by applying a rate between 0.08% and 0.2% on the taxable value of the building, determined according to the legislation in force. The taxable value of a building varies, depending on the surface area, type of construction, location, etc.

On the other hand, for non-residential buildings owned by individuals, the tax is computed by applying a rate between 0.2% and 1.3% on the taxable value of the building (ie, the acquisition value for buildings acquired within

the past five years preceding the reference year; the value of the construction works, in the case of new buildings constructed in the past five years preceding the reference year; or the value from the valuation report, as the case may be).

In case of non-residential buildings, owned by individuals, for which the value of the building cannot be determined according with the aforementioned rules (eg, no valuation report) the building tax is determined by applying the 2% tax rate to the taxable base determined according to the law for residential buildings.

In case of mixed usage, the tax is either determined proportionally or at full residential rates (eg, where no economic activity, or other economic circumstances detailed by the law).

For non-residential buildings owned by legal entities, the tax is computed by applying a rate between 0.2% and 1.3% on the taxable value of the building (eg, the last taxable value registered in the fiscal authorities' records; the value from the valuation report; the acquisition value for buildings acquired during the previous year; the value of the construction works, in case of new buildings, constructed in the previous year).

In case the building owner, legal entity, did not update the taxable value of the building in the last three years, the building tax rate is increased to 5%.

For non-residential buildings owned by both individuals and legal entities, used for agricultural activities, the building tax is calculated by applying a rate of 0.4% to the taxable value of the building.

The tax on buildings is due for the entire fiscal year by the person who owns those assets at 31 December of the previous fiscal year, irrespective of whether these assets are alienated during the reference year.

Building tax is payable twice a year, by 31 March and 30 September. The payment in advance, by 31 March of the year, may lead to a tax reduction of up to 10%, based on a decision of the local council.

The Fiscal Code stipulates that building tax is applicable on the value assessed in the leasing contract and payable by lessee for buildings subject to a financial leasing contract.

Land tax

Owners of land are subject to land tax, which is established at a fixed amount per hectare, depending on location and rank. The provision stating that land tax was not due in relation to the surface of land, which is covered by a building, has been eliminated.

The tax on buildings is due for the entire fiscal year by the person who owns those assets at 31 December of the previous fiscal year, irrespective of whether these assets are alienated during the reference year.

Building tax is payable twice a year, by 31 March and 30 September. The payment in advance, by 31 March of the year, may lead to a tax reduction of up to 10%, based on a decision of the local council.

The Fiscal Code stipulates that for land subject to a financial leasing contract, land tax is payable by the lessee.

Charges for permits and authorisations for constructions

The main permits and authorisations for constructions are described below.

Certificate for urbanism

The certificate for urbanisation is priced at a fixed amount per square metre, depending on the location, and is payable at the beginning of the construction. The tax for obtaining the certificate for urbanisation for the countryside is 50% less than the one available in urban areas.

Construction authorisation tax

Construction authorisation tax is calculated as 1% of the authorised value of the investment. Residential buildings can benefit from a 50% reduction of this tax. This tax should be paid before the delivery of certificates, notices and authorisations for construction. When the assets are brought into operation, the local authorities reconcile the construction authorisation tax value by comparing the authorised value with the real value of the assets.

Extension of availability tax

In order to extend the availability of the certificate for urbanism and construction authorisation, a 30% tax of the initially paid tax is due. Tax for the authorisation of the organisation of construction site works. This tax is assessed at 3% of the value of construction organisation works.

Additionally, there are two other taxes applicable to constructions, which are not payable to the local budget, being the most relevant:

Fee to the Construction Inspectorate

A monthly fee needs to be paid by companies to the Construction Inspectorate, amounting to 0.5% of the value of the expenses incurred for performing authorised constructions (ie, buildings and installations), as well as of the modernisation, transformation, consolidation and repair work on these constructions. Late payment penalties of 0.15% per day of delay are due, but they are capped at the value of the fee.

Tax due to the social security fund of the constructors

A monthly fee of 0.5% of the expenses incurred, as cited in the statement of works, needs to be paid to the Constructors' Social Security House.

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Real Estate Going Global

Russia

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 14 August 2020.

Real Estate Investments

General

In recent years, property investors and developers have become much more international in their outlook. Property has effectively become part of the global marketplace. In Russia, flexibility is a critical success factor for structuring any real estate investment, and comprehensive due diligence prior to any transaction is vital.

Possession of Russian land

The Land Code in effect since 2001 provides foreign legal entities with the right to purchase and own land plots, subject to some restrictions depending on the location of the plot (locations near state border, agricultural land, etc). The Land Code also gives preferences to companies (including foreign legal entities) in acquiring the land plots on which buildings owned by these companies are located. Nonetheless, in practice, barriers to private land ownership continue to exist. Currently the private ownership of land is extremely difficult to achieve in many locations, especially the Moscow city centre. In such locations, it is still generally more common for a property owner to acquire a 49-year lease rather than to own the land. The local rules governing the ownership of buildings and structures are less restrictive and many of these are owned by domestic and foreign legal entities and individuals.

Profits tax

Rental income

Rental income of landlords operating through a Russian subsidiary or a permanent establishment (PE, or branch) of a foreign legal entity is subject to Russian profits tax. Taxable profits are calculated as gross revenues less most economically justified business-related expenses, supported by relevant documentation.

Taxable profit is calculated on the basis of tax accounting records. All tax accounting entries as well as relevant tax returns are prepared in Russian rubles (RUB).

Profits from rental activities accruing to Russian entities and to foreign entities with a PE in Russia are subject to the maximum corporate profits tax rate of 20%. The tax is distributed between the federal (3%) and regional (17%) budgets, with regional authorities having the right to lower the regional share in the rate down to 5% for certain categories of taxpayers, although such reductions are not common in the real estate industry.

Rental income from immovable property received by foreign legal entities that do not hold the property through a PE in Russia is generally subject to withholding income tax levied on gross rentals at the rate of 20%. Double tax treaties (DTTs) do not provide reduced rates of withholding tax (WHT) with respect to such rental income from immovable property.

In repatriating income from rental property held in a Russian legal entity, dividends payable to foreign legal entities are generally subject to 15% WHT, subject to reduction under an applicable DTT. For property held directly by a foreign legal entity through a PE in Russia, there is no further Russian WHT (after normal taxation of the branch profits) on distributions of branch profits to the head office.

In a structure with two Russian entities in the chain of ownership, dividends paid from one Russian legal entity to another Russian legal entity would generally be subject to 13% dividend WHT (the Russian entity recipient would not pay additional profits tax on the received dividends). In cases where a Russian legal entity owns shares in a non-Russian legal entity, dividends received would also generally be subject to Russian tax at the rate of 13%. The 0% profits tax rate applies to dividends received by a Russian company if it owns no less than 50% of the capital of the subsidiary (both Russian, and foreign other than established in a country being in a “blacklist” of the Russian Ministry of Finance) for a period of no less than 365 calendar days. The Russian Ministry of Finance blacklist includes offshore countries and countries that do not support the exchange of information procedures. When dividends received by a Russian company do not qualify for the 0% rate, the 13% rate applies.

On debt financing of Russian property companies or branches of foreign entities, interest payments to non-resident companies would generally be subject to 20% WHT, subject to an applicable DTT relief. With effect from 1 January 2015, Russian tax legislation incorporated the concept of “beneficial ownership”. This has introduced the notion of being able to demonstrate the ability to determine “economic fate” of received income as well as proper legal basis

for receiving such income. The main test of beneficial ownership entails testing for transfer of the income amount (in any form including interest, dividends, royalty) to another party, who would not enjoy any tax benefits if it had received the payment directly because it is incorporated in a country with no DTT with Russia. Starting from 1 January 2017, the law obliges the tax agent (ie, the payer of income) to require in addition to certificate of tax residency a confirmation that the recipient of income is the beneficial owner of the income.

Profits' tax-deductible expenses

The major peculiarities and limitations on deductibility of expenses in relation to real estate activities are set out in the subsections below.

Tenant's capital improvements

Inseparable capital improvements of leased objects that are not reimbursed to tenants by lessors would be depreciated by tenants during the lease term at rates calculated on the basis of useful life of the inseparable improvement (eg, lift) or, in case this particular inseparable improvement is not named in the statutory classification of fixed assets, on the basis of useful life period of the fixed asset (ie, building) itself. This means that in most cases the lessee of a building would be able to deduct for profits tax purposes only part of the cost of such improvements (since the useful life of buildings/inseparable improvements typically exceeds lease terms).

Depreciation

As a general rule, depreciation of fixed assets can be charged under a straight-line or declining balance method. However, tax depreciation of buildings should generally be on a straight-line method only. The minimum annual depreciation rate for buildings is 3.33% and could be higher for certain types of buildings. Tax depreciation is charged on the historic cost of the building, net of recoverable value-added tax (VAT).

Starting from 2020, depreciation of assets that have been transferred or received under the contracts for free-of-charge use is not included in profits tax returns (except for the transfer for free-of-charge use where a taxpayer is required to do so under the Russian law, in which case, depreciation is included in expenses for profits tax purposes).

Taxpayers have the right to apply a depreciation premium and deduct for profits tax purposes the cost of investments into fixed assets of up to 10% (up to 30% in relation to fixed assets belonging to depreciation groups from 3 to 7) of the initial cost of the fixed asset in the period in which depreciation of the relevant asset starts (depreciation premium); this allowance applies also to capital improvements.

However, if a taxpayer applied a depreciation premium and then sold to the related party the relevant fixed asset within five years since the date of putting the fixed asset into operation, the depreciation premium should be reinstated and included in the taxable income of the taxpayer.

The useful life of a fixed asset, and hence the rate of depreciation to be applied for profits tax purposes, is established in the Classification of Fixed Assets, which was approved by the Russian Government for various categories of fixed assets.

Most types of buildings cannot be depreciated over less than 30 years using the straight-line method (although some limited types of buildings can have a shorter useful life). Land cannot be depreciated.

Investment tax credit

The investment tax credit regime permits the deduction of expenses on the acquisition of fixed assets directly from income tax as an alternative to depreciation. Taxpayers have a choice to apply depreciation in tax accounting or to deduct the cost of investment (cost of fixed assets acquired) directly from the corporate income tax (CIT).
The choice is available in constituent regions were an appropriate law is adopted. Up to 90% of expenses can be deducted from the regional CIT and up to 10% from the federal CIT. Considering this, the amount of regional CIT must be at least 5% of the tax base before the applying the deduction. The amount of federal CIT may be reduced to zero. The Russian regions may set a cap on the amount of the deduction. If the amount of investments exceeds the set cap, it may be carried forward for an unlimited number of years. The deduction is applicable only to newly commissioned (or modernised) assets with a useful life of three to 20 years (such as buildings, machinery, and transport).

Starting from 2020, the regime can be applied to assets from depreciation groups 3-10, except for buildings and transmission facilities. Furthermore, the regime permits the deduction of up to 100% of expenses on developing transport and utilities infrastructure and up to 80% of expenses on the building of social infrastructure.

The development of the above infrastructure should be provided for by a contract on integrated development of the area for standard housing construction.

Costs related to acquisition/lease of land

Costs related to acquisition of land from the state or municipal authorities may be profits tax-deductible under a special procedure (generally either evenly over a period of at least five years or in amount not exceeding 30% of taxable base of the previous tax period until the total amount is expensed). These provisions apply to taxpayers who enter into the relevant sale-purchase agreements within the period from 1 January 2007 to 31 December 2011.

Starting from 1 January 2012, costs related to acquisition of land plots (irrespective of who is the seller) are not deductible for profits tax purposes other than as a deduction against proceeds on any future sale with special rules for deduction of losses.

Costs related to lease of land (ie, rent payments) are generally profits tax-deductible provided that general criteria of economic justification and proper support by primary documents (eg, lease agreement, invoices, acts of acceptance, etc) are met.

Interest deductibility

Interest on debt taken out to finance business activities including investments in immovable property is generally profits tax-deductible, subject to certain specific limitations outlined below.

If the loan is recognised as controlled under the transfer pricing rules, those rules should be taken into account in determining the interest recognised for profits tax purposes. An exception to this general rule is specifically envisaged for controlled loans where interest rates are within “safe harbour” limits allowing the borrower or lender to recognise interest calculated on the debt obligation at the actual rate if it falls within the threshold. In particular, if a debt obligation is recognised as a controlled transaction and the loan is arranged in rubles, the ranges of threshold values of interest rates for debt are 75% to 125% of the Central Bank of Russia (CBR) key interest rate. For debt obligations set in currencies other than rubles, “safe harbour” limits refer to LIBOR, EURIBOR, SHIBOR rates increased by various ranges depending on the currency. If the interest rate in the debt obligation is fixed, the CBR’s key rate (LIBOR, EURIBOR, SHIBOR rates) valid for the borrowing date should be applied. If a floating rate is utilised, the CBR’s key rate (LIBOR, EURIBOR, SHIBOR rates) valid for the date of recognition of interest as income (expense) is to be applied. The CBR’s key rate has been established at the level of 4.25% since 27 July 2020. Free-of-charge loans between Russian related parties are not controlled under transfer pricing rules.

Thin capitalisation rules

Russian tax legislation provides a limitation for deductibility of interest expenses on debt obligations that are considered “controllable” for purposes of special “thin capitalisation rules”. The following debt is defined as “controllable”:

(i) Loans from a foreign related party if such a party has a direct or indirect equity interest in the Russian borrower;

(ii) Loans from a party related to the party indicated in item (i) above, unless:

- the loan is provided by a Russian legal entity or individual related with the party indicated in item (i), and which is a Russian tax resident during the entire reporting period; and
- such parties had no outstanding debt under comparable liabilities during the relevant period owed to the foreign party indicated in item (i) or ii) above (if there were comparable liabilities, the “thin capitalisation rules” should be applied only within the amount of such comparable liabilities).

(iii) Loans from unrelated parties guaranteed or otherwise secured by the party indicated in (i) or (ii) above.

Interest on loans attracted from independent banks are exempted from thin capitalisation rules (provided the debt - both principal and interest - was not repaid by a foreign shareholder or its affiliates as a result of execution of a guarantee to the bank).

With respect to this controlled debt, which exceeds the equity capital of the Russian borrowing organisation by more than three times (for banks and companies engaged exclusively in financial leasing activity by more than 12.5 times), the Russian thin capitalisation rules are applied. In such a case, the interest expense on the loan will be only partially deductible. If the amount of the “controllable debt” exceeds net assets (capital) of the borrower (calculated as per Russian statutory accounting as of the last date of each reporting period while the debt is outstanding) by more than three (or 12.5) times, the relevant pro rata amount of interest expenses corresponding to

the portion of the “controllable debt” exceeding this limit will be non-deductible for profits tax purposes of the borrower and should be reclassified into dividends and taxed correspondingly. Relevant WHT implications would apply to such reclassified interest.

Loss carryforward

Russian legal entities and foreign companies having a PE in Russia can carry losses forward and offset them against profits in future years. As a general rule, losses incurred in a particular year may be used in any year over the subsequent ten years. However, for tax periods from 1 January 2017 up to 31 December 2021, the amount of a recognised loss of prior periods cannot exceed 50% of the current year tax base for CIT purposes.

Where buildings and other fixed assets are sold at less than net tax book value, losses on such disposals should be claimed for deduction in equal parts over the remaining useful life of the property sold.

Taxation of capital transactions in property

Taxable profits from sale of property by Russian companies and branches of foreign entities are calculated as gross sales proceeds less the net tax book value of the property. Profit from the sale of property is subject to the general profits tax rate of 20%.

If Russian immovable property is sold by a foreign company without a PE in Russia, the purchaser is required to withhold tax at the rate of 20% of the capital gain if the vendor can confirm the acquisition costs with appropriate documents; otherwise, the 20% tax rate should be applied to the gross sales price. No exemption can be obtained under DTTs. The same rates and rules apply to the sales of shares in companies which directly or indirectly holds Russian real estate and such real estate constitute more than 50% of their assets. However, this income, may be protected from Russian tax under certain (although not all) applicable DTTs. It should be noted that capital gains from disposals of shares in companies and relevant derivatives are fully exempt from WHT if the shares qualify as publicly listed securities.

The 0% profits tax rate applies to income from sale of non-quoted (for the full period of holding by seller) shares in Russian companies in case at the moment of realisation these shares were held by the seller for not less than five years. This exemption applies only to the shares acquired after 1 January 2011. There is an uncertainty if this exemption may apply to such income of foreign companies.

The purchaser of Russian real property and/or shares in companies which assets are represented by Russian real estate more than for 50% (see above) who is a Russian legal entity or a foreign legal entity having a PE in Russia will be obliged to withhold the tax and pay it to Russian state budget.

Contributions to charter capital

For profits tax purposes, the cost of the property received as a contribution to the charter capital of the taxpayer generally equals the cost (net book value) determined on the basis of tax accounting of the contributing party; potentially, expenses incidental to the contribution may be taken into account. Special rules are established for situations where contributing parties are foreign legal entities or individuals. In case appropriate documentary evidence of the cost of the property is unavailable its cost will equal zero for profits tax purposes.

Value-added tax (VAT)

Generally, VAT is charged on the supply of goods, works and services in the territory of the Russian Federation at the rate of 20%.

VAT is payable on an accrual basis.

Rental of property is generally subject to VAT. Where the parties to the lease arrangement are located in different countries (for example the landlord is located outside Russia) for VAT purposes, the service is considered to be performed where the real property is located.

Under special provisions based on the concept of reciprocal treatment, accredited individuals and accredited foreign entities of some 100 countries are exempt from VAT on rental costs.

Taxpayers are required to reinstate VAT they previously recovered if they start using relevant fixed assets for non-VATable activities. In particular, VAT incurred on acquisition/construction of immovable property should be reinstated unless the fixed assets have been fully depreciated or have been used by the taxpayer for more than 15 years. This rule affects, for example, a real estate company that after, say, five years of leasing out a building

starts leasing (part of) the premises to accredited foreign legal entities that have the right to enter into a non-VATable lease. Such reinstated VAT may however be expensed (deducted for profits tax purposes).

VAT is charged on capital transactions in property (other than when a disposal is made by an individual that is not an individual entrepreneur and in some other cases). Owners of the premises (eg, investors) are in principle entitled to recover VAT incurred in relation to completed stages of construction under the general VAT recovery rules, ie, without waiting for commissioning of the building. Moreover, starting from 2009, VAT on advances paid to contractors is in principle recoverable in the period when the advance is paid, ie, before the acceptance of completed construction stages.

Where a finished building is purchased by an investor for use in a business that is VATable, input VAT incurred could in principle be recovered immediately or offset against output VAT provided certain requirements for input VAT recovery are met.

Sale and lease of residential property is generally exempt from VAT. However, in case of assignment of property rights in relation to residential premises, VAT is charged on the difference between the sale price of the rights and the cost of the rights, at 20/120 rate (eg, if during a pre-construction sales period a taxpayer obtains a right to purchase a residential unit at a pre-determined price, and then transfers that right to another taxpayer for consideration).

Special VAT rules apply when a building is constructed by the developer's own workforce ("self-construction"), rather than under a contract with a separate construction company. The value of self-construction works is included into the VATable base. However, such VAT could be claimed for recovery in the same tax period.

Transactions with securities (including shares in a property holding company) are exempt from VAT.

Certain types of imported technological equipment (components and spare parts thereof), analogues of which are not produced in Russia, are exempt from Russian VAT provided that they are mentioned in a special list approved by the Russian Government.

In the case of a contribution of assets to the charter capital of an enterprise, the contributing party shall reinstate VAT on contribution of fixed assets to the charter capital of a company that it previously recovered in relation to such fixed assets, in an amount proportionate to the net book value of the fixed assets. This reinstated VAT, however, is subject to recovery for the receiving party.

Lease of land is generally subject to VAT (there are some exemptions for cases where land lease payments are made directly to the state or municipal bodies). Sale of land plots (parts of land plots) is not subject to VAT.

Other taxes

Property tax

Property tax is levied at the maximum rate of 2.2% (the local authorities have the right to reduce the rate).

Movable property and land are not subject to property tax. The law does not provide a clear definition of what property should be considered as movable and what property is clearly immovable. In practice, the tax authorities tend to apply wide interpretation of the immovable property.

Starting from 2020, the taxable base for the property tax for Russian legal entities and Russian PEs of foreign legal entities should be defined as follows:

- Real property that is currently in use is taxed based on its average annual net book value under Russian accounting rules (excluding land).
- Shopping malls, business centres and offices (the list of properties is subject to approval by each Russian region) are taxed based on their cadastral value. The same rule applies to residential premises, construction-in-progress assets, garages, car parking spaces, as well as residential buildings, garden houses, household buildings (structures) located on land plots that have been provided for running personal subsidiary farm, vegetable and fruit gardening or individual residential housing construction (if a Russian region establishes so in its statute).

For foreign legal entities that own immovable property in Russia but do not have a PE in Russia the tax base is determined based on cadastral value. The cadastral value is publicly available in the real estate cadastre.

In Moscow, the tax rate for property with the tax base determined on the basis of its cadastral value is established by regional authorities and is: (i) 1.3% in 2018; (ii) 1.3% in 2019 and (iii) 1.6% in 2020. The tax is payable on annual basis.

Land tax

There is a levy on owners and users of land, but lessees of land are exempt from this charge. Land tax is calculated on the basis of the cadastral value of land defined in accordance with land legislation and a tax rate, which should not exceed 1.5% and 0.3% for specific land plots yearly.

Insurance contributions

The employer is required to make pay-related contributions to pension, social and medical insurance funds. The rates of the social security contributions for 2020 are as follows:

- For pension contributions, the rate is 22% of an employee's remuneration up to 1,292,000 RUB plus 10% of any excess over this cap.
- For social insurance contributions, the rate is 2.9% of an employee's remuneration up to 912 000 RUB (the rate is 1.8% of an employee's remuneration in the case of foreign nationals staying temporary in Russia).
- For medical insurance contributions, the rate is 5.1% of total employee's remuneration.

In addition to insurance contributions to pension, social and medical insurance funds, employers shall pay mandatory accident insurance contributions (AICs) with respect to payments made to employees. The AIC rate ranges from 0.2% to 8.5% of the full amount of remuneration, depending on the level of risk associated with the industry in which the employer operates.

Personal income tax

Individuals are taxed on the proceeds from property sales. With respect to residential property an individual that is a Russian tax resident can either claim a statutory allowance or calculate taxable income as a difference between sale proceeds and documented costs. The statutory allowance with respect to real estate constitutes 1 million RUB. As a general rule, if a five-year holding period has expired, the total amount of income is exempt. This exemption applies both to Russian tax resident individuals and individuals that are not Russian tax residents. Starting from 2020, the sale of a single residential property is exempt from personal income tax provided that the property has been owned by the seller for more than three years. These exemptions do not apply to entrepreneurial income of individuals.

The tax rate is 13% for Russian tax residents. Russian tax residents are individuals that have spent no less than 183 days in Russia in any 12 consecutive months (de facto not less than 183 days in a given calendar year). Russian-sourced income of individuals that are not Russian tax residents is subject to 30% personal income tax with no deductions or reliefs available.

Stamp duty

Stamp duty for registration of agreements for disposal of immovable property is 22,000 RUB (2,000 RUB for individuals). Stamp duty for notarial certification of residential mortgage contracts is set at 200 RUB and 0.3% of the contract amount for other real estate, but not more than 3,000 RUB. The duty for state registration of agreements on pledge of immovable property, ie, mortgage agreements, and for the issuance of relevant registration documents is established at 2,000 RUB for individuals and 22,000 RUB for legal entities.

Stamp duty is charged on obligatory notarisation of certain deals at the maximum amount of 22,000 RUB.

Regional and municipal taxes in Russia

The Russian tax system generally includes three "levels" of taxes: federal, regional and municipal. Federal taxes are governed by the federal laws and are effective all over the Russian Federation. Regional taxes are set by the laws of the constituent territories of Russia, based on the provisions of the Tax Code, within the limits established by the Tax Code. Rates may vary from one constituent territory to another. Local taxes are introduced by the acts of the municipalities based on provisions of the Tax Code, and rates of municipal taxes may also vary from one municipality to another. Moscow and St. Petersburg are separate constituent territories of the Russian Federation, representative authorities (city parliaments) of which set both regional and municipal taxes.

In addition, regional and municipal authorities receive specific portions of federal taxes collected in their constituent territories (municipalities) and may introduce tax incentives in respect of regional (local) portions of some federal taxes within certain limitations.

There are no restrictions on the acquisition of immovable property by:

- EU citizens with the nationality of an EU or EEA state, and
- companies incorporated under the law of a state of the EU or EEA with their registered seat, central management or main establishment in the EU or EEA.

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Real Estate Going Global

Singapore

Tax and legal aspects of real estate investments around the globe

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Real Estate Tax Summary

General

Foreign investors may invest in the Singaporean commercial property market with little or no restriction.

Residential property is divided into three main groups, as follows:

- private apartment blocks and condominium units;
- public housing developed by the authorities; and
- landed property, or houses.

Foreign investors are generally limited to investing in private apartment blocks and condominium units. They are prohibited from purchasing the following property:

- Singaporean residential landed property; and
- all the apartments within a building or all the units in an approved condominium development, unless an approval is obtained from the relevant authority.

Foreign investors are also generally prohibited from investing in Singaporean public housing.

Loan financing

Generally, banks in Singapore will not finance the full acquisition price of Singaporean commercial property. When purchasing a Singapore residential property, it is possible to finance up to 75% of the market valuation of the property. Interest payments made to Singaporean banks on borrowings to directly acquire an investment property are deductible against rental income. However, certain restrictions can apply to tax losses and excess tax depreciation (see section "*Tax depreciation and losses*" below).

Withholding tax of 15% applies to interest paid to a foreign lender which has no permanent establishment in Singapore. This rate may be reduced through the application of double taxation treaties. Interest payments made are deductible for income tax purposes against rental income subject to meeting the relevant deduction rules.

Singapore does not have formal thin capitalisation rules and as a result, it is possible to structure a Singaporean property acquisition with considerable tax efficiency. However, attention should be paid to the application of general anti-avoidance provisions and specific conditions under the relevant double taxation agreements.

Rental income

Net rental income is taxable at the corporate tax rate of 17% in the case of a company. In the case of individuals, the net rental income is taxable at the rate of 22% if they are non-resident, and at a tax rate, ranging from 0% to 22% if they are resident (the rate will depend on the total chargeable income derived by the individual tax resident during the year).

In calculating net rental income, landlords are able to deduct all related outgoings and expenses incurred, including any interest payable on loans taken out to buy the property, property taxes payable, and repairs and maintenance costs.

Commercial property landlords must also charge goods and services tax (GST), currently at 7%, on all rental income (see section "*Goods and services tax*" below).

Tax depreciation and losses

Tax depreciation on plant, furniture, fixtures and fittings is only available to those taxpayers who are carrying on a trade, profession or business. The Inland Revenue Authority of Singapore (IRAS) regards property leasing as a non-business activity in some cases, such that tax depreciation is not available.

For taxpayers who are regarded as carrying on a trade, profession or business, tax depreciation claims can generally be made on a straight-line basis over three years. Accelerated tax depreciation claims may be allowed under certain conditions. However, where the business is one of "making investments", which includes the

business of letting immovable properties, tax losses and excess tax depreciation cannot be carried forward or set off against any other income. The definition of “making investments” is not defined in the Singapore Income Tax Act (Act) and is a question of fact.

With effect from 22 February 2010, industrial building allowances (IBA) will be phased out and it will not be allowed on capital expenditures on the construction or purchase of industrial buildings or structures incurred after 22 February 2010, except in specified scenarios.

Capital expenditure, which is incurred on or after 23 February 2010 up to the date of the completion of the construction or renovation/extension of an approved building or structure, may qualify for Land Intensification Allowance (LIA). Generally, industry sectors with large land takes and low gross plot ratios may qualify for this LIA incentive. To enjoy the benefits under the LIA incentive, an applicant should obtain approval from the Economic Development Board from 1 July 2010 to 31 December 2025. Approved LIA recipients will enjoy an initial allowance of 25% and an annual allowance of 5% on qualifying capital expenditure incurred on or after 23 February 2010.

A special tax deduction is allowed for “renovation and refurbishment” expenditure incurred on certain fixtures, fittings and installations for renovations undertaken by companies. Deductions are capped at 300,000 Singapore dollars (SGD) generally over a three year period. One year accelerated claim is allowed for qualifying expenditure incurred during the financial year 2020.

Disposal of property – Tax depreciation

Where tax depreciation has been claimed on qualifying plant and machinery or qualifying industrial buildings, and that asset/property is subsequently sold, a balancing allowance or charge will be made to the vendor, depending on whether the proceeds are less than or greater than the written-down tax cost base.

Disposal of property – Capital gains tax

There is no capital gains tax in Singapore, and therefore gains on the disposal of a residential or commercial property should be tax-free unless the property has been held as a trading asset, in which case the gains will be taxed at the prevailing corporate tax rate (currently 17%). The question of what is, and what is not, a trading asset is nevertheless the subject of much debate.

Tax losses

Generally, losses incurred in Singapore that are not subject to the restrictions described above may only be carried forward against future income, on the basis that they arise from the carrying on of a rental trade or business and subject to the continuity of the shareholdings test. However, losses of up to 100,000 SGD can be carried back one year. For losses incurred during the financial year 2019, these can be carried back three years, subject to the 100,000 SGD cap. These provisions do not apply to a company that is in the business of making investments.

Withholding tax on dividends

There is no withholding tax on dividends paid by Singaporean companies.

Stamp duty

Stamp duty is levied on the sale or transfer of shares in a Singaporean company at the rate of 0.2% (on the higher of purchase price or the value of shares) unless the shares are scripless.

Stamp duty is payable on the higher of the purchase price or market value of Singapore non-residential property.

The stamp duty rates are as follows:

Purchase price or market value (in SGD)	Stamp duty rate (in %)
0 to 180,000	1
180,001 to 360,000	2
360,001 or more	3

For residential property, the stamp duty rates are as follows:

Purchase price or market value (in SGD)	Stamp duty rate (in %)
0 to 180,000	1
180,001 to 360,000	2
360,001 to 1,000,000	3
1,000,001 or more	4

The above is usually borne by the purchaser unless otherwise agreed between the relevant parties.

For residential property purchased after 8 December 2011, additional buyer stamp duty (ABSD) is also payable by the following purchasers at the corresponding rates on the total amount of consideration or value of the property (whichever is higher):

Profile of buyer	ABSD rates from 8 December 2011 to 11 January 2013 (in %)	ABSD rates from 12 January 2013 to 5 July 2018 (in %)	ABSD rates on/after 06 July 2018 (in %)
Singapore citizens (SC) buying first residential property	n/a	n/a	n/a
SC buying second residential property	n/a	7	12
SC buying third and subsequent residential property	3	10	15
Singapore permanent resident (SPR) buying first residential property	n/a	5	5
SPR buying second and subsequent residential property	3	10	15
Foreigners (FR) buying any residential property	10	15	20
Entities[1] buying any residential property	10	15	25[2] and additional 5% for housing developers[3]

A seller's stamp duty (SSD) is imposed on residential properties purchased on or after 20 February 2010 and sold within four years of acquisition. SSD also applies to industrial properties purchased on or after 12 January 2013 and sold within three years of acquisition. The current applicable SSD rates are as follows:

Holding period	Residential property[4] SSD rate (in %)	Industrial property[5] SSD rate (in %)
Up to 1 year	12	15
More than 1 year and up to 2 years	8	10
More than 2 years and up to 3 years	4	5
More than 3 years	no SSD payable	no SSD payable

1 An “entity” means a person who is not an individual. It includes the following:
- an unincorporated association;
- a trustee for a collective investment scheme when acting in that capacity;
- a trustee-manager for a business trust when acting in that capacity;
- the partners of the partnership whether or not any of them is an individual, where the property conveyed, transferred or assigned is to be held as partnership property.

2 Developers may apply for remission of this 25% ABSD, subject to conditions.

3 This 5% ABSD for housing developers is in addition to the 25% ABSD for all entities. This 5% will not be remitted and is to be paid upfront upon purchase of residential property.

4 Applicable SSD rates for residential properties acquired on or after 11 March 2017.

5 Applicable SSD rates for industrial properties acquired on or after 12 January 2013.

Stamp duty is also payable on documents relating to leases of immovable properties in Singapore.

In addition, Additional Conveyance Duties (ACD) may apply to buying or selling of shares or units (equity interest) on or after 11 March 2017 in property-holding entities (PHEs) that own primarily residential properties in Singapore. The ACD provision applies to the purchase or sale of equity interests by persons or entities who are significant owners (ie, 50%) of the PHE or who become one after the purchase.

With effect from 6 July 2018, an ACD rate of up to 34% (previously 15%) may be applicable to the buyer on the execution of instruments relating to the transfer of a PHE.

For sellers, an ACD rate of up to 12% may be applicable on the execution of the instruments relating to transfer of a PHE if the PHE was acquired on/after 11 March 2017 and disposed of within three years of acquisition.

Goods and services tax

GST, which is currently at 7%, is payable on the acquisition cost of commercial/ industrial property. However, if an investor acquires commercial property with an existing rental income stream, this may be viewed as a transfer of a going concern, which is an excluded transaction and therefore not subject to GST. GST is payable on rentals derived from commercial/industrial property, but this can be recovered by the tenant if his business is registered for GST purposes. GST is not payable on the purchase of residential property, and similarly is not levied on rentals from residential property, as these are exempt supplies.

Property tax

Property tax is payable annually and is determined by the Property Tax Division of the IRAS. Generally, it is based on the annual rental value of the property. The prevailing property tax rate is 10% for commercial and industrial properties. In the case of owner-occupied residential properties, the property tax rate is a progressive rate from 0% to 16% (from 1 January 2015 onwards). In the case of non-owner occupied residential properties except for those within the exclusion list, the property tax rate is a progressive rate from 10% to 20% (from 1 January 2015 onwards).

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

A foreign corporate or individual investor may acquire real estate in Slovakia directly (with a few exceptions, such as forest and agricultural land), or through a subsidiary, or branch registered in the Slovak Commercial Register. As of 2014, the restrictions for acquiring agricultural land and forests for certain foreigners have been cancelled in order to comply with the law of the European Union. Therefore, the residents of the European Union member states, European Economic Area, Switzerland and of countries having concluded international contracts with Slovakia, are entitled to acquire agricultural lands and forests under same conditions as Slovak citizens. If a legal entity is acquiring the real estate, the most commonly used forms of legal entities are as follows:

- joint-stock company (a.s.), ie, a corporation; and
- limited liability company (s.r.o.).

Rental income

Rental income is part of the corporate income tax base and is taxed as ordinary income. It is subject to the corporate tax rate of 21%/15%. The lower rate will apply from 2020 to taxpayers that achieve income (revenues) of up to 100,000 EUR for the relevant tax period. Rent paid to legal entities or individuals is tax-deductible on a cash (paid) basis. Nevertheless, rental payments are tax-deductible up to the amount, which actually relates to the particular tax period.

Rental income is also a part of personal income tax base, which is subject to the tax rate of 19%/25%. The tax base of up to 176.8 times the subsistence level (ie, 37,163.36 EUR for 2020) is subject to the 19% tax rate. The exceeding part of the tax base is taxed at 25%.

Depreciation

Real estate as well as other fixed assets are subject to tax depreciation on an annual basis. There are seven tax depreciation groups for assets with depreciation periods ranging from 2 to 40 years. Most buildings of a permanent nature fall into the fifth and sixth group and are depreciated 20 or 40 years respectively using a straight-line method of tax depreciation. The annual tax depreciation costs claimed on leased fixed asset (including real estate) cannot exceed the annual rental income earned on such asset. The unclaimed tax depreciation costs on leased assets due to the above limit can be claimed after the end of statutory tax depreciation period. The taxpayer can decide to interrupt tax depreciation of tangible assets for one or several tax periods. The depreciation period is then prolonged by the number of taxable periods in which the asset was not depreciated.

In most cases the applied tax depreciation charges are different from accounting depreciation charges, since the accounting ones are usually determined based on the actual lifetime of the real estate.

Tenants can depreciate technical enhancements done in rented premises if:

(i) it is agreed in a rental agreement in writing; and

(ii) provided the real estate owner did not recorder such enhancements as items increase the book value of its real estate; and

(iii) provided such enhancements were not included into the rental payments.

Land cannot be depreciated.

Financing real estate

Debt

There are thin capitalisation rules in Slovakia.

Equity

There are no limitations on financing real estate with equity.

Financing

Mortgages were introduced in Slovakia in the year 2000, and the range of mortgage products offered by banks increased thereafter.

Tax grouping

There are no tax grouping rules in relation to corporate tax in Slovakia. However, it is possible to create a VAT group in Slovakia under certain conditions.

Real estate transfer tax

There is no real estate transfer tax in Slovakia.

Real Estate Investments

Legal aspects

Ownership

Ownership of a property is a right to possess, enjoy, use and dispose with the property within the limits of the legal regulations.

Unlike in some other countries, in Slovakia the legal principle “superficies solo cedit” does not apply, ie, the ownership of land and building may be split. Thus, the building and the land may belong to different owners.

In general, ownership of a real estate is governed by Slovak Civil Code, Cadastral Act and by Act on Ownership of Residential and Non-Residential Premises as a special law governing the ownership of residential and non-residential premises.

Co-ownership

Property may be owned by two or more co-owners. In that case, the ownership is split into co-ownership shares according to the participation of co-ownership types. These are (i) common co-ownership, where the shares are exactly determinable; and (ii) community co-ownership of spouses, which applies only for married couples, and shares are not determinable, as the whole property of spouses is owned jointly and inseparably.

In case of common co-ownership, the share expresses the extent to which the co-owners participate in the rights and obligations arising from co-ownership of the common property. All co-owners are jointly and severally entitled and obliged to perform legal acts related to the common property. The co-owners decide on the management of the joint matter mostly by the size of the shares. In the event of a tie, or if no majority or agreement is reached, the court shall decide on the proposal of any co-owner.

In case of community property, property is shared by both spouses; they shall jointly reimburse the costs incurred with respect to the property or associated with its use and maintenance. Ordinary matters related to community property can be handled by each of the spouses. In other matters, the consent of both spouses is required; otherwise the legal act is invalid. Both spouses are jointly and severally entitled and obliged to perform legal acts concerning common matters.

In case that the construction and technical designation of the building allows, residential and non-residential premises within a building can be deemed independent from a legal point of view. Owners of such residential or non-residential premises then own shares of the common parts of the building.

Real estate acquisition

Preliminary negotiations and due diligence

Although negotiations can be conducted freely, there is an obligation for the parties to negotiate in good faith. Special terms may set out the basis on which the parties enter into negotiations in heads of terms or letter of intent. The existence of such a letter or agreement will enforce the obligation to negotiate in good faith. Such a document may comprise a number of assumptions. It is important to inform the other party each time an assumption proves to be incorrect or can no longer be relied on. However, heads of terms are not fully covered by Slovak law, therefore, an interpretation risk might arise and, thus, it is recommended to structure it carefully.

Preliminary contracts

It is possible to proceed directly to completion without any preliminary agreement.

However, in Slovakia it is possible to enter into a reservation agreement (RA) or an agreement on future real estate purchase agreement (AFREPA) before dealing with pre-completion formalities.

RA or AFREPA are types of agreements, where the buyer usually deposits part of the purchase price to the hands of a notary, bank or an attorney, and seller undertakes not to offer the real estate to other persons, and at the same time, the parties undertake to conclude an agreement on purchase of the real estate. The eventual deposited

“reservation price” usually constitutes a part of the purchase price. The “reservation price” can act as the contractual penalty, in case that the final purchase agreement is not concluded.

AFREPA is usually concluded, when the real estate cannot be subject to purchase (ie, is not finished, and is registered and not yet transferable).

Pre-completion formalities

The real estate purchase agreement

In the purchase agreement, both parties are committed: one party is committed to sell and the other party is committed to purchase, as soon as the property is identified, and its price agreed upon.

The real estate purchase agreement has to be in writing and the signature of the seller shall be authorised either by an attorney registered with the Slovak Bar Association, or a notary public. The signatures of both contractual parties must be on the same page of the agreement.

When the authorisation is done by an attorney, the attorney is obliged to check the identity of the contractual parties and their legal representatives, assess whether or not the agreement is contrary to the law, bypasses the law, is not contrary to good morals, and whether there are no circumstances, which could lead to damages arising for either party.

Apart from the general contractual requirements as specified above and the purchase price, the real estate purchase agreement must contain the following essentialities:

- a description of the real estate in the scope as it is defined in the deed of ownership (in case of residential and non-residential premises, there are further specific requirements, set out by the law);
- if the real estate is shared, a determination of the size of co-owner share.

Land Cadastre

Once the agreement(s) have been executed, an application to the locally competent District Office, Cadastral Department (hereinafter referred to as “Land Cadastre”) must be submitted, as the legal effect of the real estate transfer occurs only after the transfer has been registered by the Land Cadastre, by its decision.

The applicants for the registration procedure of real estate transfer are the contractual parties to the real estate transfer agreement.

The application must be made in writing and must among others contain the following:

- name, surname and permanent residence address of the contractual parties (in case of individuals), or business name, registered seat (in case of legal entities);
- identification of the respective Land Cadastre; and
- a reference of a legal act based on which the right to the real estate is being transferred (ie, the real estate purchase agreement).

The annexes, which must be attached to the application, are:

- public deed or other deed, proving the right to the real estate, if this is not a part of the deed of ownership;
- identification of land plots, on which the real estate is located;
- geometrical plan, if the land is being divided or merged, or if an encumbrance to the land is being created; and
- power of attorney, if an attorney is acting on behalf of either contractual party.

After receiving the application, the Land Cadastre assesses whether:

- the agreement is concluded in a prescribed form;
- the seller is entitled to dispose with the property;
- the expressions of will are sufficiently certain and comprehensive;
- the contractual dispositions or rights to act with the property are not restricted; and
- the contract is not contradicting or bypassing the law or is not against good morals.

If the agreement is prepared in the form of a notary deed or authorised by an attorney, the Land Cadastre only reviews whether it is compliant with the Cadastral Operate (ie, the data of the real estate and its cadastral documentation).

Provided that the criteria as described above are met, the Land Cadastre should issue a decision on transfer of the real estate within 30 calendar days. However, in practice this period can be and often is prolonged up to 90 calendar days. If the purchase agreement is prepared in the form of a notary deed or authorised by an attorney, the Land Cadastre should issue a decision within 20 days.

The applicants for the registration procedure of real estate transfer have an option to apply for an expeditious proceeding, where the Land Cadastre should issue the decision within 15 working days.

Post-completion formalities

After the real estate is validly transferred, there are no special requirements with regards to the ownership of the real estate.

Acquisition costs

The notary and attorney fees are carried by the requestor of the respective service and the fees of Land Cadastre are borne by the person, who files the application to the Land Cadastre.

Unless otherwise agreed, when transferring residential and non-residential premises, the seller generally bears the acquisitions costs.

The contractual parties may agree on a different allocation of costs bearing. However, such an agreement is not legally binding towards the notaries, attorneys and the Land Cadastre, and it is binding only between the buyer and the seller.

Notaries' and attorneys' fees and expenses

Notary's fees are calculated pursuant to Regulation on Remuneration and Reimbursements of Notaries Public depending on the type of service, and therefore it may vary and cannot be generalised.

Attorney's fees are primarily based on an agreement which must be concluded in line with good morals and the fees are calculated pursuant to the Regulation on Remuneration and Reimbursements of the Attorneys and according to one of the following:

- hourly rate (upon a specific request from the client);
- lump sum;
- as a ratio of the purchase price (up to 20%) if the attorney is representing the client with a court proceeding or proceeding before other authority; and
- tariff fee – this type of fee is used, when the client does not agree with the attorney on the price (based on a value of property and number of acts).

It is common practice to agree with the attorney either based on an hourly rate or a lump sum, taking into account specific legal action.

Land Cadastre's fee

Land Cadastre's fee is 33 EUR when the application is submitted electronically (using a qualified electronic signature), or 66 EUR when the application is submitted in a paper form.

The application for expeditious proceedings is charged by a fee of 266 EUR, if filed electronically the fee is 133 EUR.

There is an option to file an advance notice that an application will be submitted, which provides a decrease of 15 EUR of the fees.

Tax aspects

Tax-deductible costs

A company owning property in Slovakia can deduct interest expenses (apart from certain exceptions) and property-related costs, eg, tax depreciation (with exceptions as stated above), repairs, maintenance and utilities, from its taxable rental income, subject to the general conditions in the Slovak Tax Act. Property management fees can also generally be treated as tax-deductible.

Interest expenses on loans from a related party may be deducted for tax purposes, provided the following conditions are met:

- Loan principal is used to generate, secure or maintain taxable income and it is properly documented.

- The level of interest and related expenses is at “arm’s length” level (which would be supported by proper transfer pricing documentation).
- The deduction of interest and related expenses is allowed by Slovak thin capitalisation rules (ie, limited up to 25% of an adjusted current year EBITDA of the debtor).

Expenses may be also restricted for tax deductibility by Slovak anti-hybrid rules. The rules apply to situations arising between a corporate taxpayer and its related parties, eg, between a taxpayer and a subsidiary abroad, or between the permanent establishments of a taxpayer, etc. Hybrid mismatches also apply to unrelated parties that create a structured arrangement (s), ie, an agreement(s) that includes hybrid mismatch. According to the Slovak tax legislation the following situations are qualified as hybrid mismatch:

- mismatch leading to deduction without taxation of income (deduction without inclusion) due to:
  - different treatment of financial instrument;
  - different treatment of hybrid subject’s income taxation;
  - different approach to allocation of taxable income between a permanent establishment (PE) and its headquarters (HQ), or between different PEs of the sale HQ;
  - different approach to allocation of taxable income between PE and its HQ due to different approach to PE recognition;
  - payment performed by hybrid subject;
  - deemed payment between HQ and its PE or between different PE of the same HQ;
  - multiple deduction of costs without a corresponding inclusion of the multiple corresponding income.
- incorporated mismatch, where expense is used (directly/indirectly) to finance the expense which lead to mismatch as defined above.

Application of anti-hybrid rules would limit tax deductibility of expenses related to hybrid mismatches (subject to certain exemption).

According to the Slovak tax law, the tax authorities have moreover in principle the right to reclassify the transaction(s) based on its substance and not formal view in cases where the transaction does not have economic justification and where at least one of the reasons was to avoid tax payments, to reduce the tax base or to obtain tax advantages, which the taxpayer would otherwise not be able to obtain (“GAAR”).

Concerning interest expenses related to financing the acquisition of shares, such interest may be tax deductible only in the period when such shares are sold (and assuming the disposal would be taxable, ie, no participation exemption of capital gains from Slovak tax applies).

In case of individuals owning a property in Slovakia and receiving rental income, the type of deductible expenses depends on the treatment of property.

Also, the first 500 EUR (for 2020) of taxable rental income for individuals is exempt from Slovak tax, unless this exemption has already been used by the individual against other qualifying types of income. The relating expenses would then need to be appropriately reduced (recalculated) as well.

Capital gains on the sale of real estate

There is no specific capital gains tax.

Corporate owners of real estate are subject to tax on profits realised on the sale of real estate at the rate of 21%/15% for taxpayers that achieve income (revenues) of up to 100,000 EUR for the relevant tax period. Losses realised on the sale of buildings, except for a land and a real estate depreciated for tax purposes in 6th depreciation group (this limitation does not apply to technical improvement of real estate done by tenant), are generally tax-deductible for corporate income tax purposes.

Profits of individuals from sale of real estate may be exempted from personal income taxation, where certain conditions are met (ie, holding period, way in which the ownership title was obtained, etc). Otherwise, the profits are included into individual’s tax base which is subject to progressive tax rate. Please note that the overall tax base determined for all types of incomes (eg, employment income, rental income, sale of property) of up to 176.8 times the applicable subsistence level (ie, 37,163.36 EUR in 2020) is subject to the 19% tax rate. The exceeding part of the tax base is taxed at 25%.

Capital gains on the sale of shares

Income of a Slovak tax resident company from the sale of shares in Slovak and foreign joint-stock companies, ownership interests in limited liability companies, or limited partnerships (hereafter “participation”) may be exempt from corporate income tax if certain conditions are met. In particular, the following criteria should be met:

- direct holding of at least 10% of shares or ownership interests for at least 24 months; and
- Slovak tax resident company seller performs substantial functions in Slovakia, bears and manages risks associated with the participation ownership and has adequate personnel resources and material equipment to perform these functions.

However, the above tax exemption does not apply to taxpayers who trade in securities, to the sale of companies in liquidation, bankruptcy or restructuring, or to taxpayers in liquidation.

Business combinations

There are the following alternatives for the business combinations:

- sale of business as a going concern (further as "BGC");
- contribution of the BGC to share capital;
- sale of individual assets and liabilities;
- contribution of individual assets to share capital; and
- mergers and demergers.

Application of different options may allow for recognition of a step up in values of assets for tax purposes, recognition of taxable/deductible goodwill, etc.

However, the effectiveness of each option depends on the particular situation in hand. Therefore, a detailed analysis is required to choose the best option.

Exit tax

It is applicable in case of the transfer of the property, business activities or tax residency outside of Slovakia while the legal owner would remain unchanged.

In case of Slovak tax residents, or non-residents having a PE in Slovakia, that transfer any of the above outside of Slovakia (eg, to a non-Slovak PE of the Slovak tax resident), exit tax would be payable from the capital gains created in Slovakia at 15%/21% CIT.

The Income Tax Act specifies the procedure for the calculation of the tax base and other taxpayer’s obligations/options related to taxation on exit.

Value-added tax (VAT)

Currently, transactions with real estate are either subject to VAT of 20% or are VAT-exempt. Renting of real estate is generally exempt from VAT (with some exceptions, such as rent of parking places, accommodation services, etc), but the charging of an exempt rental fee limits the landlord’s ability to deduct related input VAT. To avoid this when renting a real estate to another taxable person, the landlord can opt to charge 20% VAT on the rental fee. However, renting a flat, a family house or an apartment in a residential building or parts thereof should always be VAT exempt.

The supply of real estate is VAT exempt (including the building plot on which the building is situated), except for supplies made within five years from the day when:

- the first building approval was received; or
- the building was ready to use for the first time; or
- building approval was received after performance of the construction works, cost of which comprises at least 40% of the real estate value before reconstruction (in certain cases).

The seller can decide not to apply VAT exemption on the supply of real estate. However, this option is not available for supplies of residential real estate. Also, transfers realised as a result of a finance lease contract are generally subject to 20% VAT. Supply of land is VAT-exempt, except for construction land.

If a taxpayer decides to apply the taxation of a real estate, where such supply may be VAT exempt under the VAT law, such a taxpayer has an obligation to notify the customer in writing of its decision on taxation by the deadline for issuing an invoice. In addition, if such a transaction is carried out between two Slovak VAT payers, the VAT liability would be shifted to the customer under the reverse charge mechanism.

The period for adjustment of input VAT deduction related to real estate (immovable property) in case of change of its intended use is twenty years. The period for archiving invoices received in relation to such immovable property is also twenty years.

Supply of real estate, which the seller opted to tax is subject to the reverse-charge mechanism if the customer is a Slovak VAT payer. A taxable person established in Slovakia who supplies a building, part of building or construction building land automatically becomes a Slovak VAT payer upon the sale of such goods (eg, house, apartment) if the VAT registration turnover threshold of 49,790 EUR is reached by such a sale and the seller opted to tax it.

Local reverse-charge mechanism applies in case of supplies of

- construction works;
- building or parts of buildings under the framework of the construction or similar agreements; and/or
- goods along with assembly and installation, if assembly and installation can be considered as construction works,

provided that such supplies fall under the section F of Statistical classification of products in respect of the Commission Regulation (EU) No 1209/2014 and are performed between two Slovak VAT payers, suppliers of buildings and providers of construction works to other Slovak VAT payers, if the works are listed in the mentioned section F, are not held liable for charging VAT from 1 January 2016. This obligation is transferred to their customers Slovak VAT payers who have to self-assess VAT on construction supplies under the reverse-charge procedure.

Taxation of Slovak source income

Generally, the gain from disposal of real estate located in Slovakia or the rental income from the real estate located in Slovakia is subject to Slovak taxation if paid to foreign tax resident under Slovak tax legislation.

Income of non-residents from transfer of shares in a Slovak company is also considered as a taxable income from a source in the Slovak Republic (regardless whether it is a Slovak real estate rich company or not) and is subject to Slovak taxation.

A tax securement of 19% applies to rental income and sales price paid by a Slovak entity or individual to a non-EU/EEA entity/individual for real estate/shares located in Slovakia. A 35% securement tax rate applies on payments to taxpayers from “non-cooperative states” (ie, states that did not either conclude a double tax treaty or tax information exchange agreement with the Slovak Republic, or that are included on the EU list of non-cooperative tax jurisdictions or where a Slovak taxpayer is not able to prove the beneficial ownership status of income recipient).

No tax securement is required for rental payments/income from transfer of real estate/shares paid to EU/EEA-resident entities, assuming such non-resident is beneficial owner of received income or if the non-resident pays corporate income tax advances in Slovakia. The tax securement is considered a tax advance.

The entity/individual receiving the rental income or income from the sale of real estate located in Slovakia should file a Slovak tax return, and calculate its Slovak tax base (ie, income less tax-deductible costs attributable to earning the income under Slovak tax law). If the tax return is not filed, the tax authorities can consider the tax securement (if applied) to be a final tax.

Capital gain of corporate non-resident from disposal of shares in a Slovak company is generally subject to 21%/15% corporate income tax (the lower rate applies for taxpayers that achieve income (revenues) of up to 100,000 EUR for the relevant tax period).

In practice, most double tax treaties may provide for a protection from Slovak taxation of non-resident capital gain from disposal of shares in Slovak companies. Further limitations may apply in case of the real estate rich companies due to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting (MLI) adoption. The applicable double tax treaty should be reviewed for each case specifically.

In general, dividends distributed from profits generated after 1 January 2017 in favour of non-residents are subject to:

- 7% WHT, if paid to an individual (35% WHT in case of an individual from a “non-cooperative state”);

- 0% WHT, if paid to a company, a tax resident of a “cooperative state” (there is a double tax treaty (DTT) or tax information exchange agreement in place, and the country is not listed on the EU list of non-cooperative tax jurisdictions), provided such company is the beneficial owner of income; and
- 35% WHT, if paid to a company, a tax resident of a “non-cooperative state”, (there is no DTT or tax information exchange agreement in place, or the country is included in the EU list of “non-cooperative” tax jurisdictions, or where Slovak payer of income cannot prove the beneficial ownership status of income recipient).

The WHT, if any, may be decreased by the provisions of the effective DTT.

Generally, there is no withholding tax on dividends paid by Slovak entities out of profits arising in 2004-2016, unless GAAR apply.

The domestic rate of withholding tax on royalties paid to non-Slovak entities is also 19%/35% (in case of taxpayers from non-cooperative states or where a Slovak taxpayer is not able to prove the beneficial owner status of income recipient). Under most double tax treaties, the withholding tax on royalties is reduced, often to 5% or 10%. The royalty provisions of the EU Interest and Royalty Directive were also implemented in Slovak legislation. As a result, there is no Slovak withholding tax on royalties paid by a Slovak company to a related company seated in another EU Member State that is the beneficial owner of the royalties, provided certain conditions are met.

If interest is paid by a Slovak entity to a foreign entity, it is subject to the withholding tax rate of 19%/35% (in case of taxpayers from non-cooperative states or where Slovak taxpayer is not able to prove the beneficial owner status of income recipient) under Slovak domestic law. However, most DTTs reduce the withholding tax on interest to nil. Moreover, as a result of implementation of the interest provisions of the EU Interest and Royalty Directive into Slovak tax law, interest paid by a Slovak entity to a related company seated in another EU Member State that is the beneficial owner of the interest income, is not subject to Slovak tax, provided certain conditions are met.

Slovak withholding tax is not levied on non-resident’s income sourced from Slovakia in case the foreign company receiving the income has a Slovak PE to which the gain can be attributed. However, in specific cases the tax securement may be applicable.

Transfer pricing

Under Slovak legislation, the transaction between a Slovak corporate taxpayer with foreign-related parties and Slovak related parties are subject to transfer pricing control.

The tax legislation reflects the transfer pricing methods commonly used in OECD member countries. These transfer pricing methods include comparable uncontrolled price, resale price, cost plus, profit split and transactional net margin methods. The legislation provides local tax authorities with the flexibility to use these methods, or a combination thereof, when reviewing related party transactions.

Taxpayers are obliged to keep transfer pricing documentation supporting the prices used in transactions with their foreign and Slovak related parties. Specific transfer pricing documentation must be maintained by Slovak companies, the extent of which depends on the company concerned.

Loss carryforward

A company may currently carry forward and utilise tax losses reported for tax periods

(i) starting before 1 January 2020: equally over a period of four years following the year in which the tax loss arose (ie, maximum 25% of the losses utilised per year); and

(ii) starting from 1 January 2020: over five consecutive tax periods, up to 50% of the tax base declared in the respective tax period.

Carryback of losses is not available in the Slovak Republic.

Thin capitalisation

The limit for the maximum amount of tax deductible interest and related fees on credits and loans between related parties is established as 25% of the adjusted earnings before interest costs, tax, depreciation, and amortisation (EBITDA).

In general, thin capitalisation provisions do not apply to financial institutions, real estate companies, collective investment schemes, and leasing companies. Other exceptions or restrictions may apply.

DAC 6

Slovakia has recently implemented provisions of the EU Directive 2011/16/EU on administrative cooperation in the field of taxation ("DAC 6") into its local law, imposing reporting obligation on intermediaries or clients (in case intermediaries are subject to professional privilege) in respect to the cross-border reportable arrangement - ie, arrangements involving more than one Member State or a Member State and a third country.

The cross-border arrangement is to be reportable, provided at least one of the hallmarks (generic or specific) from the list set by the act is met. Some of the hallmarks are also subject to the main benefit test (ie, where tax benefit was the main or one of the main aims of cross-border arrangement).

Municipal taxes

Real estate tax

Slovakia levies a real estate tax on companies and individuals owning land, buildings, flats or apartments, and non-residential premises in residential buildings, such as blocks of flats or apartments. Generally, the real estate tax is payable by the registered owner of the land, building, or owner of the apartment. If the taxpayer cannot be determined, the tax is payable by the user of the land, individual or legal entity who uses the building. The real estate tax is governed by the Act on Local Taxes and includes the basic annual rates.

Generally, the tax liability depends on the area of ground occupied by the real estate in square metres, the number of floors, the nature and purpose of the building and its geographical location.

Development fee

In addition to above, the municipality may establish in its territory or part of cadastral area a local one-off development fee with respect to the construction of the above-ground floors of the building. The development fee may vary from 3 EUR/sqm to 35 EUR/sqm of the above-ground floor area. Within this range, the municipality can set the fee rate for various building categories differently.

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All information used in this content, unless otherwise stated, is up to date as of 18 August 2020.

Real Estate Tax Summary

General

Non-residents may invest in South African (SA) property by direct offshore ownership of the property, or via resident companies, close corporations, trusts, share block schemes, unit trusts or real estate investment trusts (REITs).

In the case of direct offshore ownership, a non-resident company seeking to acquire SA real property is required to set up a SA branch (or, as termed in the SA Companies Act, an "external company") if it engages in business activities or is party to an employment contract in SA. There is no similar requirement for non-resident individuals.

There are few restrictions on non-residents making property investments. Dividends, rent and interest are, generally speaking, freely remittable. Certain aspects of the making and the repatriation of loans by non-residents to residents, and the payment of interest thereon, require the prior approval of the SA Reserve Bank.

Profits distributed by way of dividend are subject to a 20% dividend withholding tax (WHT) subject to any relief under applicable double tax treaties. Payments of interest on most debt to non-residents are also subject to WHT at a rate of 15%. A notable exception in this regard is with respect to listed debt.

SA also imposes local borrowing restrictions in certain cases (see section "*Deductions*" below).

Residence basis of taxation

SA applies a residence basis of taxation. This has the effect that SA residents are taxed on their worldwide income.

A resident is defined as follows:

- any natural person who is ordinarily resident in SA;
- any natural person who is physically present in SA for a period or periods exceeding 91 days in aggregate during the relevant year of assessment, as well as for a period or periods exceeding 91 days in aggregate each of the five preceding years and for a period exceeding 915 days in aggregate during those five preceding years;
- any person other than a natural person, which is incorporated, established or formed in SA, or which has its place of effective management in SA.

Non-residents are taxed on the source basis of taxation.

Rental income

Rental income derived from SA property is taxable in SA. If the property owner is a resident company or close corporation, the corporate tax rate of 28% applies. A 20% WHT will be imposed on any profits paid as dividends by these companies and/or close corporations, subject to relief under any applicable double tax treaty.

If the property owner is a non-resident company through its SA branch, the corporate tax rate of 28% applies to the branch profits and no WHT applies on the remittance of the branch income.

If the property is owned by a non-resident individual, tax rates varying from 18% to 45% apply. For the 2020/21 tax year ending on 28 February 2021, the highest rate of 45% applies to taxable income in excess of 1,577,300 South African rand (ZAR).

Deductions

Interest and other operating costs

Interest on borrowings used to acquire property is generally tax-deductible against rental income, subject to compliance with transfer pricing rules.

Interest payments made by SA residents to non-residents are subject to 15% WHT on most debt, subject to relief under any applicable double tax treaty. These payments are normally exempt from SA corporate or individual taxes in the hands of the non-resident provided that:

- if the recipient of the interest is an individual, he or she has been physically present in SA for 183 days or less in aggregate during the twelve-month period preceding the receipt or accrual of the interest; and
- the debt is not effectively connected to a permanent establishment (PE) of the person in SA.

Other operating costs incurred in deriving rental income such as the costs of insurance, repairs and maintenance, and property management fees are also deductible for tax purposes. Costs that are capital in nature, such as legal costs incurred in relation to the acquisition of the property are not deductible for income tax purposes but can normally be added to the base cost of the property when it is sold (see section "*Capital gains tax*" below).

Non-residents willing to borrow from SA banks in order to finance foreign direct investment into SA may do so, but limits are set as to the amount of borrowings for residential property acquisitions and/or financial transactions. For the latter two transactions, Authorised Dealers (ie, local banks) may grant or authorise local financial assistance facilities to non-residents, limited to 100% of the rand value of the funds introduced from abroad and invested locally. The effect of the limitation essentially creates a 1:1 ratio between foreign investment funding and locally sourced borrowings.

It should be noted, however, that if non-resident holding companies require local borrowings in excess of the 50% limit, the Financial Surveillance Department may on application review the local borrowing restriction.

SA substantially revised its thin capitalisation provisions with effect from years of assessment commencing on or after 1 April 2012. In terms of the new rules, thin capitalisation is now dealt with purely as a transfer pricing analysis. This means that direct loans (or loans guaranteed by foreign connected persons) granted by foreign connected persons are now subject to the "arm's length" principle.

No "safe harbour" is applicable in the case of thin capitalisation.

In addition to the transfer pricing provisions, an interest-deduction limitation also applies in the case of certain interest that is not subject to either income tax or the WHT on interest in the hands of the recipient. This limitation applies

- where the debtor and creditor are in a "controlling relationship", being a relationship where a person directly or indirectly holds at least 50% of the equity shares or voting rights in a company;
- where the debtor or creditor is not in a "controlling relationship" but the funding was obtained by the creditor; or
- the funding was obtained from a person that is in a "controlling relationship" with the debtor.

In such a case, the deduction is limited to an amount determined in accordance with a formula which limits the deduction to a percentage of adjusted taxable income (essentially a tax EBITDA).

Cost of obtaining finance

Costs of obtaining finance, including legal costs and securities transfer tax, are normally regarded as being of a capital nature and so not tax-deductible. Interest, however, is normally deductible. The raising fees are in most cases treated in the same way as interest.

Depreciation and building capital allowances

Depreciation and building capital allowances used to be available only if the buildings were used in the industries of manufacturing, provision of residential accommodation, hotel keeping, farming, mining, or in terms of special urban renewal projects, provided certain requirements were met. From 1 April 2007, the depreciation allowance was extended to all other commercial buildings as well. In addition, allowances have been introduced for buildings used in research and development (R&D) activities and for airport and port buildings.

Deductions in respect of manufacturing buildings

The write-off rate for manufacturing buildings and improvements thereto depends on the date when the construction of the building or the improvement commenced, as shown below:

Date when the building was erected	Annual write-off rate (in %)
Before 01 January 1989	2
On or after 01 January 1989	5

During the relevant year of assessment, the building must be used wholly or mainly for the purposes of carrying on therein, in the course of the taxpayer's trade, a process of manufacture or any other process, which is of a similar

nature. With regard to the term “mainly used”, in practice the South African Revenue Service (SARS) requires that more than 50% of the building must be used for the manufacturing process.

If the building is leased to another person, the lessor may only claim the allowance if the tenant uses the building wholly or mainly for carrying on therein a process of manufacture or similar process, in the course of the tenant’s trade.

The allowance is granted in respect of buildings erected or purchased by the taxpayer, provided, in the case of a purchased building, that it was not used by the seller or that the seller was entitled to the allowance.

The annual allowance is granted in full when the building is brought into use and is not apportioned where the building is used only for part of a year. It must be noted that where offices are erected simultaneously with the manufacturing buildings, they will qualify for the deduction; however, where the office space is erected at a later stage, it will fall outside the scope of the allowance.

The annual allowance may be recouped when the building is sold, or the recoupment may be set-off against the cost of a further building, if the taxpayer purchases or erects a building within 12 months or any further period which the Commissioner may allow. The new building must in itself meet the requirements to qualify for the allowance.

Deductions in respect of residential units

With regard to transactions concluded before 21 October 2008, the taxpayer may deduct a 10% initial allowance, and a 2% annual allowance, in respect of the cost of erection of a residential unit in a housing project. A housing project is defined as being a project for the erection of a building or buildings in SA, consisting of at least five residential units.

A residential unit is defined as any self-contained residential accommodation consisting of more than one room, excluding any hostel, hotel or similar accommodation, the erection of which was commenced by the taxpayer on or after 1 April 1982, but before 21 October 2008, and which was erected under a housing project either to be leased to a tenant for the purpose of deriving a profit, or to be occupied by a bona fide full-time employee of the taxpayer.

Where the building is erected on leasehold property, the allowance will only be granted if the taxpayer is entitled to occupation for ten years from the date of commencement of erection.

The allowance in respect of any unit will be granted in the tax year during which the unit is leased or occupied for the first time, provided that at least five units have been leased or occupied. When a unit is no longer used as intended, the full initial allowance, less one-tenth for each completed year, but not exceeding 10 years, that the unit was leased or occupied by employees, will be recouped. In addition, the annual allowance will not be granted for that or any succeeding year, during which the building was not used as intended. The initial allowance may be recouped, but only to the extent that it has not already been included in taxable income when a unit becomes unavailable for leasing or occupation.

With effect from 21 October 2008 the taxation of residential units was revised, and significant legislative changes introduced. In terms of the new legislation, taxpayers have the benefit of an allowance for both the cost and improvements to residential units.

In order for the legislation to find application the taxpayer must own a new and unused residential unit, the unit or improvements must be used solely for the purposes of a trade carried on by the taxpayer, it must be situated in SA and form one of at least five residential units owned by the taxpayer. Low-cost residential units will qualify for the allowance except where the units will be provided to employees who carry on the trade of mining.

Low-cost residential units are defined as either stand-alone units with a cost not exceeding 300,000 ZAR or apartments with a cost not exceeding 350,000 ZAR. In terms of the Act, the owner of such property may not charge a monthly rental fee in excess of 1% of the total cost (plus a proportionate share of the cost of the land and the bulk infrastructure where the cost of the building is less than 300,000 ZAR); furthermore, the cost figure will be increased by 10% annually for purposes of calculating the rental charge.

In terms of the allowance an amount equal to 5% of the cost of any new and unused residential unit (or improvements) is allowed as a deduction from the income of the taxpayer. Where the transaction relates to low-cost residential units as defined, an additional 5% of the cost is allowed as a deduction against income.

The cost of residential units or improvements constitutes the lesser of the actual cost, incurred by the taxpayer, of the asset, or the direct cost under a cash transaction concluded at “arm’s-length” on the date on which the transaction for the acquisition, erection or improvements were concluded, including the direct cost of the acquisition, improvement or erection of the residential unit.

Where a part of a building was acquired, and the taxpayer did not construct or erect it the cost is 55% of the acquisition price if a part is acquired and 30% of the acquisition price if an improvement is acquired.

In terms of low-cost residential units and improvements the legislature has developed a regime whereby employers who provide low-cost residential units to employees via interest-free loans can claim a deduction.

The employer will be entitled to claim 10% of the outstanding loan at the end of the year of assessment as a deduction; this allowance can be claimed over a maximum of ten years. Furthermore, the amendment contains a recoupment provision for any amounts paid back to the employer in respect of the loan, the deemed recoupment will be limited to the lower of the amount repaid on the loan, or the amount claimed as a deduction.

Deductions in respect of hotel buildings

The write-off rate, or annual allowance, for qualifying hotel buildings and improvements thereto is 5%, if erection commenced on or after 4 June 1988. If erection commenced before 4 June 1988, an investment allowance of 10%, and an annual allowance of 2% are granted. It is important to note that the cost of the hotel forms the basis for the calculation of the allowance; accordingly, the land value will be excluded. Furthermore, the allowance will only be available where the taxpayer erects the building and not where it is purchased. Improvements to hotel buildings which do not extend the exterior framework of the building, and which commenced on or after 17 March 1993, qualify for a write-off rate of 20%.

Depending on when the erection of the building or qualifying improvements commenced, the different rates that are applied can be summarised as follows:

Date when the building was erected	**Annual write-off rate (in %)**
Before 4 June 1988	2
From 4 June 1988 onwards	5
From 17 March 1993, in respect of improvements that do not extend the exterior structure of the building	20

The annual allowance granted in respect of the building or improvements is limited to the cost of the building or improvements.

The annual allowance may be recouped when the building is sold, or the recoupment may be set-off against the cost of a further building, if the taxpayer purchases or erects a building within 12 months or any further period which the Commissioner may allow. The new building must in itself meet the requirements to qualify for the allowance.

Deductions in respect of plant and equipment

Certain limited components of buildings may be considered to be plant and equipment. These are generally depreciable for tax purposes over their useful lives. Qualifying items include air conditioning, with a write-off period of six years (the recommended write-off periods for air-conditioning acquisitions on or after 1 March 2009 are six years for a window type, five years for a mobile unit and ten years for a room unit), lifts, with a write-off period of 12 years, and demountable partitions, with a write-off period of six years. Values for depreciation depend on the allocation of the purchase price of the property specified in the purchase contract.

Deductions in respect of buildings used in farming and mining

The cost of buildings erected for farming or mining purposes is generally deductible in full in the year when it is incurred. However, any deductions relating to mining or farming are usually ring-fenced and deductible only against income received from the respective business, with the excess being carried forward to the next year.

Deductions in respect of leasehold improvements

A tenant who is obliged to effect the improvements on the land or buildings used by him/her is eligible for an allowance based on the cost of improvements, provided that the land or buildings are used by the tenant in the production of income and that the value of the improvements constitutes income in the hands of the lessor. The annual allowance is equal to the cost of the improvements divided by the number of years during which the tenant has the right of use in respect of property, but not more than 25 years.

Where the improvements have been effected in terms of an agreement and the value has been provided for in that agreement, the allowance will be limited to such amount.

Where no value has been agreed in the contract, the commissioner may limit the allowance to an amount he/she deems fair and reasonable. In practice the fair and reasonable cost to the lessee is taken as the value to be used.

Special rules apply where the improvements are to be made on land owned by any sphere of the government of SA. Improvements made in compliance with these rules will be deemed to be owned by the person making such improvements for the purposes of all the other allowances available and will have to meet all the requirements of the other sections as well to entitle the taxpayer to the allowance. In addition, an allowance is also available in certain circumstances for improvements made to land or buildings where the government of SA enjoys a right of use.

Deductions in respect of urban development zones

An accelerated depreciation allowance is available in respect of the cost of erection, extension, addition, or improvement of commercial or residential buildings located within demarcated areas within certain municipalities (as published by the Minister of Finance in the Government Gazette). The allowance is available for property developers as well as other taxpayers who bring derelict or obsolete buildings back onto the market, provided that the building is used solely for the taxpayer's trade.

The allowance will come into effect where the taxpayer incurred expenditure on the erection or improvement of both residential and commercial buildings; the taxpayer must own the building and can lease such property where it was acquired from a developer. It is imperative that the building be situated in the demarcated areas and used solely for trade purposes.

In terms of buildings that have been purchased, the contract of sale must have been concluded on or after 8 November 2005 and the allowance must not have been claimed by the developer. Furthermore, the allowance will not be available where the building ceases to be used solely for purposes of trade, was disposed of in the previous year of assessment, or was brought into use after 31 March 2020. In general, the allowance can be calculated as follows:

Where a new building is erected or an existing building is extended, 20% of the cost of erection or extension in the year in which the building is first brought into use and 8% in each of the succeeding 10 years.

Where an existing building, or part of that building is improved (refurbished) without changing its structural or exterior framework, the allowance is 20% of the cost of the improvement in the year in which it is brought into use and 20% in each of the succeeding 4 years.

In respect of low-cost residential units, in respect of any erection, extension, addition or improvement commencing on or after 21 October 2008 the allowance is as follows:

- Where a new building is erected or an existing building is extended the allowance is 25% in the year in which the building or extension is brought into use, 13% in the following 5 years and 10% in the last year.
- Where an existing building, or part of that building, is improved (refurbished) without changing its structural or exterior framework, the allowance is 25% of the cost of the improvement in the year in which it is brought into use and 25% in each of the succeeding 3 years.
- Where a part of a building in an urban development zone was purchased from the developer, the allowance will be available but limited in the following manner:
  - 55% of the cost if the part of the building was erected or extended by the developer; and
  - 30% of the cost if the part of the building purchased was improved by the developer.

Deductions in respect of research and development buildings

For expenditure incurred before 1 October 2012, the allowance for the cost of buildings used for R&D activities of the taxpayer is 50% of the cost in the first year of use, 30% in the second and 20% in the third year. This allowance does not extend to the R&D relating to social sciences, humanities, marketing, business processes and management, or to any activities related to the development of trademarks.

From 1 October 2012, but before 1 October 2022, buildings used for R&D purposes are subject to an allowance at a rate of 5% per year.

Deductions in respect of airport and port buildings

A 5% annual depreciation for airport buildings has been available since 2001. The asset is deductible to the extent that the asset is used in the production of income. From 1 January 2008, this depreciation was extended to port buildings as well.

Deductions in respect of commercial buildings

The deductions described above do not extend to a wide range of commercial buildings such as offices, shopping malls, warehouses and any other buildings used by taxpayers for the purpose of producing income in the course of their trade.

From 1 April 2007, a deduction of 5% yearly of the cost of the building or improvement thereto can be claimed for all such buildings (except those used for the provision of residential accommodation). To qualify for the allowance,

- the building or improvement has to be new and unused;
- that building and improvement is wholly or mainly used by the taxpayer for purposes of income in the course of taxpayer's trade; and
- the erection or construction thereof must have commenced after 1 April 2007.

Deduction in respect of buildings in special economic zones

A 10% allowance will become available for the cost of any new and unused building which is owned by the taxpayer in a special economic zone. In order to qualify for this allowance, the taxpayer will have to use the building (or improvements thereto) for purposes of deriving income in a special economic zone, excluding the provision of residential accommodation.

These provisions are effective for years of assessment commencing on or after 9 February 2016 and has a sunset date, being years of assessment commencing on or after 1 January 2024. The sunset clause is currently being reconsidered and may change to years of assessment commencing on or after 1 January 2028.

Capital gains tax

Capital gains tax (CGT) was introduced in SA from 1 October 2001 and applies to capital gains or losses realised on or after that date.

CGT applies to the disposal on or after 1 October 2001 of SA resident's worldwide assets and the following assets of non-residents:

- immoveable property situated in SA held by that person, or any "interest" or rights of whatever nature of that person to, or in immovable property situated in SA.
- an "interest in immoveable property" situated in SA includes an interest of at least 20% held by a person (alone or together with a connected person), in the equity of a company, or in any other entity, if, at the time of disposal, 80% or more of the market value of such shares or interest is directly or indirectly attributable to immoveable property situated in SA. This excludes immoveable property held by a company or other entity as trading stock.
- any asset that is attributable to a permanent establishment of that person in SA.

A capital gain arises where the proceeds received for the disposal of the asset exceeds the base cost of the asset. Special inclusions and exclusions exist for both the determination of the base cost and proceeds in respect of such assets. Generally, the base cost includes the direct cost of acquisition of the immoveable property as well as certain indirect costs such as valuation fees, consulting, legal, accounting or agent fees, transfer duty and advertising costs. These indirect costs extend to both the acquisition and disposal of the asset.

Net capital gains are included in the taxable income of a taxpayer at the following inclusion rates, for years of assessment commencing on or after 1 March 2016:

- 40% for individuals and special trusts (ie, trusts formed to benefit a minor child, or a physically or mentally handicapped person); and
- 80% for all other taxpayers, including companies and other trusts.

The effective CGT rates for years of assessment ending prior to 1 March 2016 are as follows for the following entities:

Type of taxpayer	Inclusion rate (in %)	Statutory rate (in %)	Effective rate (in %)
Individuals	33.3	0-40	0-13.3
Individuals (01/03/2015 until 29/02/2016)	33.3	0-41	0-13.7
Trusts	66.6	40	26.7

Companies	66.6	28	18.6
PEs (branches)	66.6	28	18.6

For years of assessment commencing on or after 1 March 2020 the effective CGT rates and statutory rates are as follows:

Type of taxpayer	Inclusion rate (in %)	Statutory rate (in %)	Effective rate (in %)
Individuals/Special trusts	40	0-45	0-18
Other trusts	80	45	36
Companies	80	28	22.4
PEs (branches)	80	28	22.4

Gains realised on the sale of property are generally subject to CGT. Certain exemptions, however, exist in this regard, eg, an exemption of the gains from the sale of the property used as a primary residence to the limit of 2 million ZAR or an exemption of the gains from the sale of the property, during years of assessment commencing on or after 1 March 2009, for proceeds of 2 million ZAR or less, provided the property was used as a place of ordinary residence and only used for domestic purposes for the total period of ownership and an annual exclusion of 40,000 ZAR, regardless of the type of gain, for individuals and special trusts.

Loss carryforward

In general, revenue losses may be carried forward indefinitely and may be used to offset future taxable income. However, the tax advantage of the revenue losses is lost when the taxpayer ceases trading for a full year of assessment. Losses incurred by a trust cannot be used by the beneficiaries, and these losses will remain in the trust to be used to offset future taxable income earned in the trust.

Where an individual incurs losses from letting of fixed property, these losses may be ring-fenced and can only be set off against rental income of future years. The ring-fencing applies only where the person is in the highest tax bracket and there is no reasonable prospect of deriving taxable income from rental within a reasonable time period.

Capital losses will only be deductible against capital gains, and not against revenue income. If an assessed capital loss is sustained, the loss is carried forward to subsequent years, to be used to offset any future taxable capital gain.

Dividends and withholding tax

Dividends paid by a SA resident company or close corporation are potentially liable to dividends tax and subject to WHT at 20% of the dividend paid by the company to the beneficial owner of the dividend. This WHT is paid by the company declaring the dividend from the amounts withheld on behalf of the beneficial owner, who bears the ultimate burden of the tax.

Certain persons are exempt from the dividends tax. This exemption applies in general to SA tax resident companies, government and certain government entities and regulated intermediaries (in respect of listed shares).

Real estate transfer duty

The acquisition of legal title to a property in SA is subject to a real estate transfer duty.

Currently, the rate for all persons is on a sliding scale:

Value of property (in ZAR)	Rate (in %)
0 – 1,000,000	0
1,000,001 – 1,375,000	3% on the value above 1,000,000 ZAR
1,375,001 – 1,925,000	11,250 ZAR + 6% on the value > 1,375,000 ZAR
1,925,001 – 2,475,000	44,250 ZAR + 8% on the value > 1,925,000 ZAR

2,475,001 – 11,000,000	88,250 ZAR + 11% on the value > 2,475,000 ZAR
> 11,000,000	1,026,000 ZAR + 13% on the value > 11,000,000 ZAR

Taxpayers engaged in corporate reorganisation transactions as envisaged in the Income Tax Act (eg, asset-for-share transactions, amalgamation transactions, intra-group transactions, etc) will obtain relief from transfer duty.

Value-added tax (VAT)

If the seller is a registered VAT vendor, VAT is levied on the transaction at a rate of 15% from 1 April 2018 (prior to 1 April 2018 14%) or 0%. If this is the case, no transfer duty would be payable on the transaction. If a registered VAT vendor acquires property from another VAT vendor and pays VAT, or acquires property from a non-registered VAT vendor and pays transfer duty, the VAT or notional input VAT amount paid may be reclaimed as an input VAT credit, provided that the property will be used for the purpose of making taxable supplies.

In the case of a purchase from a non-VAT vendor, the notional input credit for the VAT vendor purchaser is permitted but will be deferred to the extent that actual payment is made and until the property is registered in the purchaser's name.

Other relevant taxes

Securities transfer tax (STT) is imposed at the rate of 0.25% on the transfer of all securities of companies incorporated in SA as well as foreign companies listed on a recognised exchange.

In addition, STT will arise on the transfer of a members' interest in a close corporation, the cession of dividend rights and on the cancellation/redemption of securities. STT is calculated on the higher of the consideration paid, or the market value.

On death, estate duty is levied on SA real property in the deceased estate. The rate applicable is 20% of the taxable value of the estate for the first 30 million ZAR (above 30 million ZAR the tax rate is 25%), less an exempt amount, which is currently 3.5 million ZAR. Estate duty is not payable on the part of the estate inherited by a surviving spouse.

Donations tax is payable on certain donations made by any resident. The applicable rate is 20% for the first 30 million ZAR and thereafter the rate increases to 25%, payable on the value of any property disposed of under any donation. In the case of a natural person, donations not exceeding in aggregate 100,000 ZAR in a tax year will be exempt from donations tax. Other persons have a donations tax exemption of 10,000 ZAR.

Local municipalities levy rates on land. These rates are based on a percentage of the municipal valuations of land and improvements and vary from municipality to municipality. Generally, a higher rate is levied on properties zoned for business use.

Withholding taxes on sale of property

Any person who purchases SA immoveable property from a non-resident must withhold a percentage of the purchase price and pay it over to SARS, if the purchase price of the property exceeds 2 million ZAR. The withholding constitutes 7.5% of the purchase price if the seller is an individual, 10% if the seller is a company and 15% if the seller is a trust.

If the purchaser knows or should reasonably have known that the seller of the property is a non-resident and fails to withhold the tax, he/she will be personally liable for the amount not withheld as prescribed. This, however, does not apply if the sale was effected with the assistance of an estate agent or conveyancer.

A purchaser may apply for a directive from SARS granting him/her permission not to withhold or to reduce the amount of the withholding in respect of the above-mentioned tax depending on the circumstances.

Specific vehicles

Real estate investment trust (REIT) regime

With effect from 1 May 2013, a formalised REIT regime commenced in SA, bringing a sense of familiarity to foreign investors owing to the fact that the REIT regime attempts to mirror international best practice.

A REIT may take the form of either a company listed on a recognised exchange or a trust in the form of a collective investment scheme that owns and operates income-producing immovable property.

In essence, a REIT is a mere conduit through which net property income flows to the investors. This “flow through” principle means that the investors are subject to tax on income received from the REIT, while the REIT itself will be taxed on taxable income retained at the standard corporate tax rate. However, a REIT is required to distribute at least 75% of its taxable earnings each year, meaning that a REIT will invariably claim a deduction of a significant amount from its income. This mechanism of required distributions and “qualifying deductions” that in essence match the distribution creates the “flow through” structure and results in a minimum amount of monies being taxed in the hands of the REIT.

Capital gains or losses on the disposal of immovable property are disregarded by the REIT. In addition, capital allowances relating to the following may not be deducted in respect of immovable property:

- leasehold improvements;
- buildings used in a manufacturing process;
- buildings used by hotel keepers;
- erection or improvement of buildings in the urban development zones;
- commercial buildings; and
- certain residential units.

For SA investors, the tax consequences of investing in a REIT, are that there is no exemption from income tax in relation to distributions received from the REIT. Consequently, the tax consequences in the hands of each shareholder will depend on the nature and profile of the shareholder concerned.

If the shareholder is not an exempt entity, the distribution received from the REIT will be included in the shareholder’s gross income to be taxed at 28% if the shareholder is a company or at the marginal rate applicable to the individual.

Individuals disposing of shares in a REIT will be liable for capital gains tax at that person’s marginal position to a maximum effective tax rate of 18%. Companies will be liable for capital gains tax at an effective rate of 22.4%.

Certain institutions such as pension funds are exempt from tax and will therefore not be taxed on the distributions received from a REIT.

Non-residents may be subject to capital gains tax on the disposal of shares in a REIT where that person held (directly or indirectly and together with any connected person) at least 20% of the shares in the company and at least 80% of the gross assets of that company were attributable to immovable property. SA’s ability to impose capital gains tax in these circumstances may still be subject to the allocation of taxing rights by an applicable Double Taxation Agreement (DTA).

Beneficiaries and trusts

Whether trusts or the beneficiaries are subject to income tax depends on whether or not the beneficiaries have a vested right to the income or capital of the trust.

Where a beneficiary has a vested right to the income of the trust, the trust is ignored for tax purposes and the income is taxable in the hands of the beneficiary at the appropriate individual or corporate rate. In this case, it is also the beneficiary who can claim the deductions and allowances which, however, are limited to the income from the trust. Any excess deductions can be carried forward to the next year.

The same look-through approach applies to capital gains. Capital losses, on the other hand, will never be “passed on” to a beneficiary and have to be contained in the trust.

Where no vested right exists, the income and capital gains are taxed in the hands of the SA resident trust. Any after-tax distributions to a beneficiary are not subject to tax in the hands of the beneficiary. Income retained in the trust is taxed at a flat rate of 45%.

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South Korea

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

General

Real estate investment in South Korea may be structured in a tax efficient manner by using tax efficient investment vehicles such as a real estate fund (REF) under the Capital Market Law, or real estate investment trust (REIT) under the Real Estate Investment Company Act.

This summary has been prepared to help foreign investors who intend to invest in real estate in South Korea by providing a discussion of major tax issues related to real estate investment. As tax incentives for real estate investment are complicatedly enumerated in various tax laws, regulation and tax-exemption ordinances set forth by local governments, this summary does not cover these issues. As noted above, there are various issues to be carefully reviewed regarding real estate investment in South Korea. In this regard, it is highly recommended that you consult with a tax adviser in South Korea before making any decision on investment in real estate in South Korea.

Taxes on the acquisition of real estate

Acquisition tax

A person acquiring real estate must pay an acquisition tax, which is normally equivalent to 4.6% of the acquisition value including surtax, within 60 days from the acquisition date. If the purchaser fails to report the acquisition, a 20% penalty tax for failure to file is imposed. If the company is a Korean company incorporated in the Seoul metropolitan area, a heavy tax rate of 9.4% applies to the acquisition of real estate acquired within five years from incorporation. However, a REF or REIT established on or before 31 December 2021 is not subject to the triple tax rate.

National housing bond

A person registering an acquisition of real estate with a court must purchase a national housing bond (NHB), issued by the government. The applicable rate ranges from 2-5% for land and 0.8-2% for building depending on its location and the standard market value. The standard market value is determined annually by the government. However, foreign investment enterprises under the Foreign Investment Promotion Act are partially or fully exempt from the NHB purchase requirements when the acquired real estate is registered to be used for business purposes.

Value-added tax (VAT)

A person who acquires a building (land is exempted from VAT) from another person who supplies it independently in the course of business, must pay VAT equivalent to 10% of the actual acquisition value to a seller. In turn, the seller has to pay the output VAT to the relevant tax office. If the person is a VAT-taxable entity, the person may deduct the input VAT paid upon purchasing a building from the output VAT.

Taxes on possession and operation of real estate

Property tax on a building

A person who owns a building shall pay property tax which is levied at a rate of 0.3% (including education surtax of 20% of the property tax on building) of 70% of statutory standard price as of 1 June of each year by 31 July.

Property tax on land

A person who owns land shall pay property tax ranging from 0.24% to 0.48% (including education surtax of 20% of the property tax on land) is levied on 70% of statutory standard price as of 1 June of each year by 30 September.

Comprehensive real estate holding tax

Comprehensive real estate holding tax ranging from 0.6% to 0.84% (including agricultural and fishery surtax) is levied on 80% of statutory standard price as of 1 June of each year exceeding 8 billion South Korean won (KRW). After the Local Tax Law amendment, comprehensive real estate holding tax will also be levied on the real estate owned by REIT starting in 2021.

Income tax on rental income

An individual having income from real estate rentals shall pay individual income tax on such income at rates ranging from 6.6% to 46.2% including surtax, depending on the tax base. Various deductions are available.

The tax rate applicable to a corporation (including resident surtax) is depending on the income at the following rates:

Income (in KRW)	Tax rate (in %)
Up to 200 million	11
Between 200 million and 20 billion	22
Between 20 billion and 300 billion	24.2
More than 300 billion	27.5

Deduction of interest expenses

Interest incurred in the ordinary course of business is deductible as long as the related loan is used for business purposes. However, there are a number of exceptions to the general rule, as follows.

Interest expense paid to an overseas related company that exceeds 30% of taxable income before depreciation and interest of the domestic company is not deductible. Also, interest on loans related to non-business purpose assets or funds loaned to related parties is not deductible.

If borrowings from a foreign shareholder or from a third party under a payment guarantee by the foreign shareholder exceed two times the equity of the relevant foreign shareholder, the paid interest and discount fee as to the relevant excessive portion is not deductible and treated as a dividend payment.

Also, construction loans and loans for the purchase of land and fixed assets up to the date on which the assets are acquired or completed must be capitalised as a part of the cost of the asset and depreciated over the life of the asset. Interest after the date of completion or acquisition is deductible as incurred.

Depreciation

A taxpayer may claim depreciation expenses as business expenses to the extent that the expenses are recorded in the financial statements. Depreciation expenses over the limit set by the tax laws are not deductible for tax purposes. In addition, a taxpayer is required to report its depreciation method and useful lives of depreciable assets to a tax office. For corporate income tax purposes, buildings are required to be depreciated by using the straight-line method. Under the current corporate income tax law, a taxpayer may select useful lives of depreciable assets within a range from 75% to 125% of the standard useful lives prescribed in the law. Generally, the standard useful lives of steel-frame buildings and structures are 40 years.

Taxes on transfer of real estate

Income tax on gains from transfer of real estate

The tax rates for an individual normally range from 6.6% to 46.2% including surtax, depending on the amount of the tax base and how long the real estate was owned by the transferor.

The tax rate applicable to a corporation (including resident surtax) is depending on the amount of the tax base which is the income for the regular corporate income tax.

Income (in KRW)	Tax rate (in %)
Up to 200 million	11
Between 200 million and 20 billion	22
Between 20 billion and 300 billion	24.2
More than 300 billion	27.5

VAT on transfer of building

A person transferring a building must collect VAT amounting to 10% of the transfer value from the acquirer and make a payment to the relevant tax office.

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Real Estate Tax Summary

Direct taxation

Investment through a Spanish subsidiary

The net income of a Spanish entity is taxed at 25%. When investing through a real estate investment fund or company, a reduced rate of 1% applies. The Spanish REIT (SOCIMI) is subject to a corporate income tax of 0% and is applicable to qualifying subsidiaries of REITs listed in the EU or EEA.

Financial expenses capping rule

The financial expenses-capping rule limits tax relief for net financial expense to 30% of the operating profit, with a minimum of 1 million EUR treated as tax deductible. Disallowed financial expenses can be carried forward without temporary limitation, increasing the interest expense in the subsequent years, which will be subject to the 30% limit (with the exception of the period of liquidation and winding up).

Depreciation

Generally, an annual 2% depreciation charge on property (exclusive of land) is allowed. The depreciation charge allowed for industrial buildings is 3%. Depreciation rates can be doubled in the case of buildings considered as used assets, ie, of more than ten years.

Loss carryforward

Tax losses incurred by a PE or Spanish subsidiary can be carried forward without temporary limitation and may offset capital gains or ordinary income with a limit of 70% of the previous taxable base or 1 million EUR if higher (50%/25% if net turnover exceeds 20 million EUR/60 million EUR).

Withholding tax

Dividends payable to the parent foreign company are withheld at a 19% rate on the gross or at a reduced rate, which on average is 10%, provided by the relevant double taxation treaty.

Provided that the conditions under the Parent-Subsidiary EU Directive are met, dividends paid to EU resident companies will not be subject to withholding in Spain. However, the Spanish anti-abuse clause and beneficial ownership must be carefully considered.

Interest is also subject to a 19% withholding tax or at a reduced rate depending of the relevant treaty applicable. However, interest payable to EU resident lenders is withholding tax exempt. However, beneficial ownership must be considered.

In principle, rents are subject to a 19% withholding tax. However, this withholding may be avoided by the landlord if a Business Tax certificate is obtained.

Capital gains on the sale of property

Capital gains are taxed at a 25% rate.

Capital gains on the sale of shares of real estate companies

The disposal by a non-resident entity of shares in Spanish entities in which the assets are mainly composed of Spanish property is subject to a 19% tax rate, unless the sold shares are held by a company resident in a state where the double tax treaty between that state and Spain does not grant Spain taxing rights over capital gains stemming from the disposal of shares of a Spanish real estate company.

Direct investment through a permanent establishment (PE) in Spain

A business structure (permanent place of business, employees, empowered agent, or any other treaty requirement) is needed for a PE. The net income (gross income minus interest, depreciation, salaries and other expenses) is taxed at a 25% rate.

When the income obtained by the PE is transferred abroad, complementary taxation of 19% on gross income is levied. This does not apply when the head office is located within the EU, or when the relevant double taxation treaty does not recognise such an additional tax, subject to reciprocity conditions (which is the case in the majority of the cases).

Direct investment without a permanent establishment

Non-residents operating in Spain without having a Spanish PE are taxed at 24% on their gross income, ie, no deduction of expenses is allowed. However, EU residents without a PE would be taxed at 19% and should be allowed to deduct those expenses allowed pursuant to the Individual Income Tax Act, when they are individuals, and those allowed pursuant to Corporate Income Tax Act, when they are entities, as long as they are directly related to the income obtained in Spain and the taxpayer can provide supporting evidence that this is the case. The resulting scenario would be that regular net income obtained by EU residents without a PE would be taxed at 19% compared with taxation at 25% on net income obtained by PEs. In addition, capital gains taxation stands at 19% for non-residents without a PE as opposed to 25% for PEs.

Indirect taxation

Value-added tax (VAT)

In general terms, the acquisition of new buildings and urban land are subject to VAT at a rate of 21%.

Transfers of rural lands, and used buildings are exempt from VAT. Used for this purpose means that the building is transferred for the second or subsequent time, except when the building is acquired for rehabilitation or demolition for a new development. Nevertheless, the option to VAT may be implemented and, accordingly, the transfer may be subject to VAT under certain circumstances. Additionally, in such a case, the transfer would be subject to the reverse charge rule.

Letting of commercial property is always subject to 21% VAT.

Transfer tax

A transfer tax, ranging from 6% to 11%, depending on the location of the real estate, is levied on transfers not subject or exempted from VAT. The transfer of real estate qualifying as a going concern is subject to transfer tax as opposed to VAT.

Transfers of shares in property rich companies should be exempt from Transfer Tax, unless the transaction is aimed at avoiding those taxes payable if the transaction had been structured as an asset deal.

Stamp duty

Normally, a 0.5% to 2.5% stamp duty arises jointly with VAT, and when some transactions related to real estate operations are documented in a public deed, such as mortgages, new building deeds, etc.

Municipal taxes

Business tax

Any business developed in Spain is subject to business tax levied on a yearly basis. Its cost will depend on the specific activity carried out by taxpayers. Business activity tax is deductible for corporate tax purposes.

Exemptions are available: First two years of activity; Taxpayers with an annual turnover under 1 million EUR (according to the last corporate income tax return filed); individuals.

Real estate tax

Real estate tax is levied on an annual basis and the tax rates may range from 0.4% to 1.135%, applicable to the cadastral value of urban properties, and 0.3% to 0.9%, applicable to the cadastral value of non-urban properties. Such a rate is increased or decreased by the local authorities, depending on the specific location of the property. The taxpayer is the owner of the real estate. Real estate tax is deductible for corporate tax purposes.

Tax on increase of value of urban land

A tax on the increase of the value of urban land will accrue upon the transfer of urban land. The taxpayer is the seller. It is a deductible expense for corporate tax purposes.

Tax on construction, installation and building projects

A tax levied on construction, installation and building projects applies to the effective cost of the work. The taxpayer is the owner of the construction work, not necessarily the owner of the building. It is a deductible expense for corporate tax purposes.

The maximum tax rate will be 4%, depending on the municipality in which the works are carried out.

Real Estate Investments

Understanding the basic principles

Legal environment

Definition of real estate activities

For legal purposes, the definition of real estate promoter is included in the Building Act (*Ley de ordenación de la edificación*) and is legally defined as any person, individual or entity, public or private that individually or collectively decides, promotes, schedules and finances with its own or other resources, the building works, to be enjoyed by itself, or to be sold or leased.

For legal purposes, the definition of real estate lessor is included in the Civil Code and in the Urban Leases Law (*Ley de arrendamientos urbanos*), and is legally defined as the person, individual or entity that leases urban real estate, either a dwelling, or premises for commercial activities.

For tax purposes, the definition of real estate activities is included in the VAT Act, and in the Local Revenue Act regarding business tax. For corporate tax purposes, there is no specific definition, nor are there any specific regulations applicable to real estate promoters or lessors; so accounting rules are applicable to determine the taxable income of these activities, taking into account the exceptions contained in the Corporate Tax Act.

Please note that, as from March 2005, there are more obligations for lawyers, notary publics, accountants and entities in charge of real estate-related activities, among others, to obtain and deliver information periodically to the Executive Service of the Commission for the Prevention of Money Laundering and Monetary Offences (SEPBLAC).

The property right

The private property right is contained in the Spanish Constitution and regulated in the Civil Code and other civil regulations. According to the Constitution, no one can be deprived of their property except in the case of just cause of public utility or social interest, by means of the corresponding indemnification established by law.

The transfer of private property must be recorded at the Land Registry in order to be enforced vis-à-vis third parties.

As well as the registration of the property and in rem rights held over a plot with the Registry, the physical reality of the plot in the form of a graphic representation is recorded at the Cadastre (*catastro*). As the information contained in these entities may differ, a reform of the Mortgages Act in 2015 has established a regulation in order to coordinate information.

Public property is recognised both in administrative regulations and in zoning regulations. The public authorities can own premises under private legislation and public legislation.

The ground lease right (*derecho de superficie*)

This in rem right is a special right over the surface of the plot, which permits the construction of buildings over or under the land that does not belong to the constructor. It may also be granted over existing constructions. The granting of this right implies the division of the ownership of the plot between the owner and the ground lessee until the end of the stipulated term. Once that term has expired, all the constructions owned by the ground lessee will be the property of the owner.

As of November 2015, the ground lease is regulated in the Spanish Land Act. This Act provides that the ground lease must be granted by the owner of the plot before a Notary Public, and the deed must be recorded at the Land Registry, in order to be legally established. The term of the ground lease cannot exceed 99 years in any case.

Construction right

According to the Spanish Land Act, the owner of a plot has the right and the responsibility to construct. However, the owner must obtain specific licences, and be aware of having to comply with several compulsory rules, failing which the ultimate sanction could be the demolition of the construction.

Usufruct right and other figures of divided property

The Spanish Civil Code contemplates the right to use and have the benefit of the plot granted by owner to another person. This right can be onerous or free and can be for the entire life of the person to whom it is granted or, on the contrary, just for a specified term.

This right can be recorded at the Land Registry in order to be enforceable vis-à-vis third parties, for which purpose it is granted before a Notary Public prior to the recording.

Regarding other figures of divided property, indivisible property (*propiedad pro-indiviso*) is worthy of mention. This is a kind of property owned by two or more persons indivisibly, ie, it not being possible to make a physical division of the property among the different persons that own the plot in a specified percentage.

Another form of divided property is the regime of community of owners of a building (*propiedad horizontal*). According to the Spanish Horizontal Property Law, the building is divided into premises or flats, which are owned by one or many persons as separate property, as the case may be, and certain common areas that belong as indivisible property to the community. This is similar to the concept of condominium ownership.

These two types of divided property are regulated by the Civil Code, Mortgages Act and other civil regulations. They can be recorded at the Land Registry in order to be enforceable vis-à-vis third parties.

Finally, the time-sharing property scheme should be considered, as explained below.

Lease contracts

Lease agreements are specifically included in the Civil Code, which distinguishes between urban leases and rural leases. With respect to urban leases, these are regulated in the Urban Leases Law, distinguishing between residential and non-residential urban leases.

Although they are considered personal rights, lease agreements can be recorded at the Land Registry, pursuant to the Mortgages Act, in order to be enforceable before third parties who can acquire the premises.

Administrative concessions

The public authorities can grant administrative concessions over plots or premises with public utility in favour of natural persons or legal entities, selected by tender. According to these concessions, the concessions can carry out works and develop activities in order to obtain profits.

These concessions are regulated by Administrative Law and Civil Law. They can be recorded at the Land Registry over the plot in order to be known by third parties.

Town planning regulations

The urban planning competence for legislation is transferred to the regional authorities (*autonomous communities*) in Spain, with the exception of the regional authorities of Ceuta and Melilla, where the central state authorities have legislative capacity.

On the other hand, the town halls also have competences in several kinds of planning proceedings as well as all the matters related with the granting of the building licences.

The urban planning laws regulate three different areas, which are the following:

- Zoning: it is the first step of the Urban Procedure and defines the different kind of planning instruments. The main document under planning regulation for each municipality is the General Master Plan (PGOU). It is the cornerstone of Spanish planning law. It is a general and comprehensive town and country planning document and relates to an individual municipality. The PGOU establishes the main rules and guidelines and also chooses which planning model applies. The practical achievement of the PGOU depends on the class of land, which is established by the PGOU itself and various other planning instruments.
- Management: it refers to the development and implementation of the projects that Spanish Administration use to organise and distribute the land in some specific areas, attending the town planning elaborated by local administrations. The object is to redistribute between the owners all the rights and charges that result from the plan.
- Licences and authorisations: for the development of activities in premises. Although the regulation of these authorisations and licences varies from one municipality to another, there are four basic different types of licences necessary to build and carry on a business in Spain from a general point of view:

– a building licence (*licencia de obras*);

– an activity licence (*licencia de actividades e instalaciones*);

– a first occupation licence (*licencia de primera ocupación*); and

– an opening or operating licence (*licencia de apertura o funcionamiento*).

Licences are regulated by regional regulations (*normativa autonómica*) and finally, municipal regulations (*normativa municipal*). Depending on the region, the regulation of the licences may change. It has to be taken into account that the licences are granted by the town hall authorities. This means that the process to obtain the licences may vary in the different municipalities regarding term, resolution, documentation requested, etc.

Tax environment

This section analyses the general principles governing Spanish taxation of real estate investments. In this respect, it should be noted that the analysis of the particular tax provisions that might be applicable in the different Spanish autonomous communities, and especially in the Basque Country, Navarra and the Canary Islands, are outside of the scope of this brochure.

The scope of Spanish taxation

Under Spanish domestic law, income and capital gains triggered by Spanish real estate properties are taxable in Spain, whether realised by a Spanish resident or non-resident. Moreover, Spanish law provides for the taxation in Spain of capital gains stemming from the sale, by a non-resident, of the shares of a company, whether or not Spanish, whose principal assets consist of Spanish properties.

The application of these provisions to non-residents depends on the contents of the tax treaty that binds Spain and the country of residence of the owner of the properties or shares of real estate companies.

Most of the tax treaties concluded by Spain stipulate, according to Article 6 of the OECD Model Convention, that real estate income is taxable in the country where the property is located. Yet, only through a case-by-case analysis will it be possible to determine whether Spain has the right to tax or not.

Income/Capital gains tax

There are no separate taxes for income and capital gains in Spain.

Resident entities

Spanish resident entities are subject to Spanish corporate tax on their worldwide net income and capital gains.

Taxable income generated by resident companies is subject, as a general rule, to a flat corporate tax rate of 25%.

For corporate tax purposes, the starting point to determine taxable net income and capital gains is the company's annual accounts. Nevertheless, adjustments are normally required in order to bring the annual accounts figures in line with tax rules.

Rules governing the accounting results are contained in the Commercial Code, Corporations Act and in the General Accounting Plan. New Spanish GAAP rules came into effect as of January 2008.

Net income is generally determined on an accrual basis, ie, income has to be attributed to the year to which it economically pertains.

Spanish tax regulation requires that transactions carried out between related parties comply with "arm's length" principles. Transfer pricing regulations oblige taxpayers directly to price their intercompany operations at "arm's length" and impose the obligation to make available to the tax administration, documentation that justifies the prices applied. All domestic and international transactions between related entities must be valued at "arm's length" for tax purposes and be duly documented.

Corporate tax returns must be filed annually, within 25 calendar days following the six months subsequent to the end of the tax period.

Corporate tax must be paid on a prepayment basis at periodical intervals throughout the financial year.

Joint ventures (*unión temporal de empresas*, or UTEs)

Joint ventures are especially used by construction and engineering companies when a contract is given to more than one company. They are treated as Temporary Consortia companies, not paying corporate tax on the part of taxable income imputable to the member resident company. However, this tax regime will not be applicable to the portion of the taxable base of the joint venture attributable to non-resident members. This taxable base is taxed at the general tax rate of the corporate income tax, ie, 25%.

Community of owners and civil partnerships

Income corresponding to communities of owners and partnerships that carry on business activities as entrepreneurs will be attributed to common owners or participants, respectively, in accordance with the rules or agreements applicable in each case.

These are forms used to develop real estate activities in Spain in order to avoid the tax and administrative costs of incorporating a company. Notwithstanding the above, special care regarding the liability regime applicable to the members of these forms must be considered. Both of them are regarded as VAT taxpayers.

Participatory account contract (contrato de cuentas en participación)

This is a type of legal contract whereby an owner of land transfers, or merely allows an entrepreneur named as a management participant, normally the constructor, to use the land. As consideration for such use, the management participant must pay a portion of the profits obtained in the developing of the real estate promotion, or in the business carried out on the land, to the non-management participant.

The remuneration paid by the management participant to the non-management participant, ie, the owner of the land transferred or contracted to the management participant, is tax-deductible for corporate tax purposes.

Resident individuals

Resident individuals are subject to Spanish personal income tax on their worldwide income.

Trusts are not specifically recognised under Spanish law.

The personal income tax base shall be taxed at the progressive rates stated in the state and autonomous communities' scales with a marginal tax rate of 45%. Nevertheless, capital gains generated are subject to the following tax rates (in tranches): 19% for gains up to 6,000 EUR, 21% between 6,000 EUR to 44,000 EUR, 23% for gains above 50,000 EUR. Under Spanish personal income tax legislation, income stemming from real estate assets can fall within the following categories:

- returns on real estate;
- business earnings, determined pursuant to corporate tax rules;
- capital gains or losses.

Capital gains and losses derived from properties applied to the real estate activity carried out as a business activity, such as the facilities used for the real estate activity, shall not be considered as business earnings, and will be taxed according to the tax regime applicable to capital gains and losses described below.

Net wealth tax

Before 2008, resident individuals were subject to wealth tax on their worldwide net wealth, and non-resident individuals on their net assets located in Spain. However, a law passed in December 2008 abolished this tax in practice through a 100% tax rebate with retroactive effect to January 2008 for both resident and non-resident individuals. However, in 2011 regions were entitled to reintroduce this tax.

Non-resident entities and individuals

Non-resident entities and individuals are subject to taxation in Spain solely on their Spanish source income.

The basis for taxation of a direct property investment in Spain held by a non-resident will depend on the status of the non-resident for Spanish tax purposes. Permanent establishment (PE) investment is taxed at a 25% rate on the net income and capital gains. On the other hand, non-PE investment is taxed at a rate of 24% on the gross income, plus a separate rate of 19% on the capital gains.

However, EU residents without a PE are taxed at 19% and should be allowed to deduct those expenses allowed pursuant to the Individual Income Tax Act (if individuals), and allowed pursuant to the Corporate Income Tax Act (if companies), as long as they are directly related to the income obtained in Spain and the taxpayer can provide supporting evidence that this is the case. In particular, this means that, for real estate lease activities carried out by an EU resident with no fixed place of business in Spain, the taxable base would be made up of rental income less expenses as opposed to the current gross rental income system.

Spanish domestic legislation provides a 19% branch tax applicable to entities' PE investments, but not to individuals. This tax can be avoided when the head office is resident in an EU member country, or in a country that has signed a treaty with Spain, which does not contain any provisions on branch tax, subject to reciprocity conditions.

Value-added tax (VAT)

General

The basic concepts of the Spanish VAT regime, such as taxable persons, nature of the goods, delivery of goods and supply of services, have been made consistent with the 6th EC Directive. As a result, Spanish VAT regulations are comparable to those applicable in the other EU Member States. VAT grouping rules are available.

The current Spanish standard VAT rate is 21%.

For VAT purposes, a PE exists when a real estate is leased in Spain. The PE for VAT purposes must be registered before the Spanish tax administration as a VAT taxpayer, even when it would not be considered as PE for income tax purposes.

VAT-registered entities are required to file VAT returns on a quarterly or monthly basis (dependent on the quantum of turnover). Where a Spanish VAT-registered company was in a net VAT repayment position in respect of a calendar year, a refund could be claimed during January of the following year (general regime). The Spanish tax authorities would then have a period of six months in which to make a repayment where due, after which point the tax authorities would also be liable to pay repayment interest. In order to alleviate this financial cost, net input VAT can be recovered on a monthly basis. Notwithstanding the above, a VAT taxpayer can apply for the monthly refund system in order to anticipate the possibility to request a VAT refund. Under this regime the taxpayer can request a VAT refund on a monthly basis (the period available for the Spanish tax authorities to make the refund is the same as the one previously stated, six months). VAT taxpayers registered in the monthly refund system must file VAT returns on a monthly basis and are automatically included in the Immediate Supply of Information System whereby VAT taxpayers are obliged to submit certain VAT information almost on an immediate basis before the Tax Administration.

Transfer of property

For Spanish VAT purposes, property qualifies as goods and the transfer of property as a supply of goods.

The general rule is that the transfer of newly developed or redeveloped property located in Spain carried out by VAT taxpayers is subject to VAT, whereas the transfer of used property is VAT-exempt and subject to transfer tax.

In addition, the transfer of urban land carried out by VAT taxpayers is subject to VAT, whereas the transfer of land that does not fulfil the qualification for urban land is subject to transfer tax.

However, Spanish VAT legislation provides a specific rule for VAT-exempt real estate transfers, so that the transaction may be VAT-able. In case the option for VAT is implemented, the reverse charge rule will be applicable.

On the other hand, the acquisition of shares in property rich companies should be exempt from transfer tax, unless the transaction is aimed at avoiding those taxes payable if the transaction had been structured as an asset deal.

Letting of property

Supply of services means any transaction that does not constitute a supply of goods. Supplies of services on property fall within the scope of Spanish VAT with the exception of the lease of dwellings, which is exempt from VAT and subject to transfer tax.

Other indirect taxes

Transfer tax

Transfer tax can be an important cost factor, not only in asset deals, but also in share deals.

Transfer tax is levied on the transferee of the property, varying the rate from 6% to 11%, depending on the autonomous community in which the property is located, on the fair market value of the property at the time of

acquisition, when the transferee is a non-VAT taxpayer, or when the transfer is declared VAT-exempt. The transfer of real estate qualifying as a going concern is subject to transfer tax as opposed to VAT.

Transfer tax is also levied on income arising from the leasing of dwellings, at a reduced tax scale on an annual basis.

Capital tax

Capital tax may be applicable under an indirect investment structure carried out through a Spanish company. Even though incorporations and share capital increases are exempt, decreases of share capital and winding-up of Spanish companies are subject to capital tax at 1%.

Stamp duties

Stamp duties are incompatible with transfer tax, but not with VAT. Therefore, the transfer of a property subject to VAT can also be subject to stamp duties, at a 0.5% to 1.5% rate – depending on the location of the property – applicable to the value of the transferred asset, provided that the transfer is documented in a public deed and that such deed has to be registered in a public registry.

Notwithstanding the above, when real estate is acquired in a VAT transaction as a consequence of the waiver of the applicable exemption, the tax rate could range between 0.5% and 2.5%, depending on the autonomous community.

Mortgages are subject to stamp duties also at a rate of 0.5% to 1.5%, depending on the location of the property. No stamp duties are levied on any other kind of loans, even participating loans or any other kind of debt instrumented in securities, provided that they are not secured by a mortgage.

Local taxation

Local taxation may have a relative importance, depending on the characteristics of the activity, in particular:

- business tax, on the specific activity carried out by taxpayers;
- real estate tax, on the ownership of the property;
- tax on increase of value of urban land, upon the transfer of urban land; and
- tax on construction, installation and building projects, applicable to the effective cost of the work.

Direct purchase of assets

Legal aspects

The pre-contract: purchase option, promise to sell/buy

A pre-contract, such as purchase options or the promise to sell or buy, can be executed before a notary public or, alternatively, privately between parties. They can be recorded at the Land Registry according to what is established in the Mortgages Act and other applicable regulations.

Purchase option

In the pre-contract known as the purchase option, the seller, referred to as the promisor, undertakes during a certain term, the obligation to sell the property (object of the contract) to the other party, the beneficiary on the date when the beneficiary gives notice of its will to buy the said property.

The fact that the beneficiary accepting the promise by signing such a preliminary contract does not in any way represent an undertaking to buy. The beneficiary simply acknowledges the promise of the seller, the only party bound by the contract.

When the beneficiary exercises the option to buy, the sale is completed. Failing this, the seller is released from their promise, and is free to sell the premises to a party other than the beneficiary.

There can be an option price fixed by mutual agreement between the parties.

The purchase option will be enforceable vis-à-vis third parties if it is duly recorded at the Land Registry. For such recording, the requirements according to the Mortgages Act are as follows:

- mutual agreement between the parties in relation with the recording;

- the price for the acquisition of the premises and, if any, the price established for the option; and
- term to exercise the option, required to be less than four years, except in the case of a lease with purchase option, in which the term will be the same as the lease. But in case of extension of the lease, the option expires.

Promise to sell/buy

According to the Spanish Civil Code, the promise to buy or sell, when there is an agreement between parties concerning the object and the price, will give the parties the right to claim the performance of the contract. This means that these types of contracts imply a reciprocal undertaking binding the parties to perform it.

Exchange control regulations

The acquisition of real estate valued more than 3,005,060.52 EUR, or the incorporation of a Spanish subsidiary or a branch made by non-Spanish nationality investors, is considered as foreign investments in Spain, and needs to be communicated to the Investment Registry belonging to the *Ministerio de Economía y Hacienda*, once it has been carried out (unless the foreign investor is located in a tax haven) and only for information purposes.

The acquisition of any real estate by an investor located in a territory previously defined as a tax haven is also considered a foreign investment in Spain. If the foreign investor is located in a tax haven, the communication mentioned above needs to be submitted to the Investment Registry before the execution of the investment.

Tax aspects

VAT/Transfer tax

The following operations, when carried out by VAT taxpayers, are subject to VAT:

- transfer of property or rights on property;
- urban land (ie, land ready for development) or land under urbanisation in progress (ie, preparing the infrastructure for development of the area) at the 21% rate;
- buildings still in construction, at the 21% rate;
- first transfer of new dwellings, at a 10% rate, or at a 4% rate if under “official protection” regime;
- first transfer of other new premises and commercial buildings at the 21% rate;
- transfers of buildings for rehabilitation, at the 21% rate;
- transfers of buildings to be demolished, in order to carry out a new real estate promotion, at the 21% rate.
- transfers of purchase options on real estate, at the 21% rate; and
- transfers of a ground lease right, at the 21% rate.

Otherwise, transfers of used buildings and rural land are, in general, exempt from VAT, and subject to transfer tax. However, Spanish legislation provides a rule for renouncing such an exemption, in order to submit the operation to VAT taxation.

On the other hand, the acquisition from non-VAT taxpayers of property located in Spain is subject to transfer tax, varying the rate from 6% to 11%, depending on the location of the property, and being the taxable base the fair market value of the property at the time of acquisition.

Option to VAT

This is a commonly used procedure that does not need prior approval from the tax authorities.

In order to qualify for a waiver, it is required basically that the buyer must be a VAT taxpayer, eligible for the full or partial recovery of input-VAT borne on the acquisition, so that the transaction may be VAT-able. In this respect, it should be noted that the option for a VAT-able transfer is based on a strict formal procedure that needs to be followed carefully in order to avoid transfer tax.

The advantage of the option for a VAT-able transfer is that, as opposed to VAT, transfer tax will not be completely recoverable by the buyer, although transfer tax will be partially recoverable via the corporate tax depreciation of the relevant assets.

In addition, it is worth mentioning that the reverse charge mechanism is applicable to those scenarios where the option to VAT is implemented by the seller. The self-charge mechanism means that the buyer will self-charge VAT.

A condition of the option to charge VAT is that the buyer may fully or partially deduct input VAT borne on the acquisition of the property, such that self-output VAT would be (at least partially) deductible at the buyer's level.

VAT recovery

Under Spanish rules, VAT can be deducted once a company or entrepreneur begins to output VAT. Notwithstanding the above, the company or entrepreneur is allowed to do a provisional deduction before they begin to output VAT. Such provisional deduction has to be regularised through the application of the average deduction rate corresponding to the first four years of business or professional activities in which the company or entrepreneur will output VAT.

Stamp duties

The transfer of a property subject to VAT is also subject to stamp duties, at a 0.5% to 2.5% rate – depending on the location of the property – (rates are typically higher if the option to VAT has been implemented), provided that the transfer is documented in a public deed and that such deed has to be registered in a public registry.

Acquisition of an entrepreneurial activity as a whole

It is also to be noted that, under Spanish VAT legislation, the transfer of the entrepreneurial activity as a whole may not be subject to VAT. This implies that the buildings transferred as a result of the transfer of the entrepreneurial activity would be subject to transfer tax.

However, the transfer of a leased property would be treated as a regular transfer subject to VAT, provided that neither material means, nor staff are transferred.

Acquisition of a Spanish property company

Legal aspects

There are two kinds of companies that limit the liability of its shareholders for the amount of share capital previously contributed by each of them. These companies are the limited liability company, or *sociedad de responsabilidad limitada* (S.L.), and the private limited company, or *sociedad anónima* (S.A.).

In both cases, the incorporation requires the granting of a public deed, and its registration at the Mercantile Registry. The regulation on corporate agreements, corporate administration, books and records, annual accounts, audit reports and acts subject to be filed with the Mercantile Registry, are substantially similar for S.L. and S.A.

With respect to the formal requirements of the purchase of shares, it is important to notice the difference between these two types of companies. These differences are detailed below.

Private limited company (*sociedad anónima*)

The transfer of shares is different in the cases of registered shares and bearer shares:

- Registered shares do not have to be granted before a Notary Public or recorded at the Mercantile Registry. The Spanish Companies Act states that once the managers of the company have checked the transfer of the shares, they have to record it in the Shareholders Book. The Spanish Companies Act also provides that the registered shares can be transmitted by endorsement.
- Transfer of bearer shares does not need to be granted before a Notary Public or registered. Only the transmission title is required, according to what is established in the Commerce Code.

If the transfer of any kind of shares implies the transformation into a sole partner company, this new condition has to be included in a public deed and recorded at the Mercantile Registry according to the aforementioned Act.

Limited liability company (*sociedad de responsabilidad limitada*)

The transfer of S.L. shares must be executed in a public deed granted before a Notary Public and has to be registered at the Shareholders Book according to the Spanish Companies Act.

There is a pre-emptive right of purchase granted to the rest of the shareholders.

If the transfer of shares implies the transformation into a sole partner company, this new condition has to be included in a public deed and recorded at the Mercantile Registry according to the aforementioned Act.

Tax aspects

Transfer tax

Transfers of shares in property rich companies should be exempt from both VAT and Transfer Tax, unless the transaction is aimed at avoiding those taxes payable if the transaction had been structured as an asset deal.

The law lists those share deal scenarios deemed to avoid the payment of taxes corresponding to a real estate transfer, unless evidence is provided to the contrary:

1. The acquisition of the direct control of an entity whose assets are mainly made up of Spanish real estate not tied to a business activity. This also applies to increases of control.
2. The acquisition of the direct control of an entity holding a controlling stake in another entity whose assets are mainly made up of Spanish real estate not tied to a business activity. This also applies to increases of control.
3. The transfer of shares acquired as a consequence of a contribution of real estate assets upon the incorporation or the increase of capital in a company, provided that such assets are not treated as related to a business activity and the transfer happens within the 3 year period following the contribution.

Building/Rehabilitation of real estate

Legal aspects

Construction contracts

In Spain there are two types of construction contracts: public construction contracts regulated by the Law of Contracts of the State (*Ley de contratos del sector público*), and private construction contracts regulated by the Civil Code and/or the Building Act.

Public construction contracts are celebrated by public authorities and public entities that grant the construction of public works to a private company chosen by public tender. On the other hand, private construction contracts are celebrated between individuals and/or entities, and are denominated as construction leases, or *arrendamiento de obras*.

The building rehabilitation

The duty of building rehabilitation was contained in the previous Urban Planning Laws, as well as the Urban Planning Act published in Spain in 2015, which is currently in force. Article 15 of this Act states that the owners of any kind of construction must comply with the regulations related to rehabilitation that are developed by the regional and municipal authorities.

The rehabilitation is normally reserved for those constructions that have any cultural or historic value. In many cases, it is only applied to parts of constructions that are considered valuable by the zoning authorities. Notwithstanding, this duty can be applied to any kind of construction in case the competent authorities may consider it.

Tax aspects

Income tax

As stated in the Spanish domestic rules, construction, installation and assembly works, the duration of which exceeds 6 months, constitute a PE, and shall therefore be taxed as such. Nevertheless, when a tax treaty applies, its rules have to be examined, as they can introduce a different period of duration of the works in order to consider the existence of a PE in Spain.

Tax on construction, installation and building projects

This tax is levied on construction, installation and building projects and is applicable to the effective cost of the work. The taxpayer is the owner of the construction work, which is not necessarily the owner of the building. This tax is a deductible expense for corporate tax purposes.

The maximum tax rate will be 4%, depending on the municipality where the works are carried out.

Financial investments in Spanish real estate

Legal aspects

Real estate investment companies are closed-ended collective investment institutions that take the form of private limited companies (*sociedades anónimas*), the main purpose of which is investing in urban real estate to be leased. Real estate investment companies may be self-managed or managed by a management company. In case of self-managed real estate investment companies, the majority of the Board members and the top management must have proven experience in real estate and financial markets.

In the same way, real estate investment funds are collective investment institutions that have as principal purpose investing in urban real estate to be leased. Real estate investment funds must be managed by a management company. The majority of the Board members and the top management of the management company must have proven experience in real estate and financial markets.

General notes on collective investment institutions

The minimum share capital of real estate investment companies is 9 million EUR.

The minimum equity of real estate investment funds is 9 million EUR.

Both real estate investment companies and funds may create sub-funds with different characteristics (eg, investment policy, fees scheme), each of them with a minimum equity of 2.4 million EUR.

The minimum number of shareholders of real estate investment companies, and the minimum number of unitholders of real estate investment funds is 100 (20 per sub-fund if applicable).

Accordingly, with these rules, there are no limitations in the sense that an individual or entity may have a majority interest in a collective investment institution.

Transitory period concerning the investment policy

For newly incorporated collective investment institutions, and in respect of their investment policies, there is a transitory period of three years from its formal registration with the *Comisión Nacional del Mercado de Valores* (CNMV) in order to fulfil the legal requirements regarding the investment policy. Once this transitory period is completed, all the requirements regarding the investments in urban real estate must be fully completed or, if this is not the case, the entity could lose its legal consideration as a collective investment institution.

The applicable Spanish regulations concerning investments managed by these real estate investment institutions provide for several additional requirements to be observed during the transitory period. These requirements relate to such areas as type of eligible financial instruments and diversification rules.

Investment regime

Real estate collective investment institutions must invest in urban real estate to be leased such as dwellings, offices, commercial facilities, or students' and elderly residences. In addition, these institutions can invest in real estate in construction phase, options, or real rights over real estate and administrative concessions that allow for the lease of real estate.

Real estate investment companies and real estate investment funds must invest at least 80% and 70% (respectively) of their total assets in real estate. The rest of their assets can be invested in certain type of listed securities.

Real estate investment funds must maintain a minimum 10% liquidity ratio over the total assets of the previous month shall be maintained in those months were unitholders of real estate investment funds have a redemption right.

With each type of institution, no single property can represent more than 35% of the institution's total assets (calculated at the time of its acquisition).

Properties that make up the assets of these entities cannot be sold during a three-year holding period, unless express authorisation of the CNMV is granted.

These entities can only carry out certain real estate promotions.

The borrowed funds of collective investment institutions cannot exceed 50% of the institution's total assets.

Restrictions on operations with directors, administrators, managers, participants and partners of these institutions

Restrictions exist relating to the purchase, sale or lease of the assets of real estate investment companies and real estate investment funds to their directors, managers, participants and partners. In addition, restrictions exist relating to the acquisition by these institutions of properties from companies of the same group, or which form part of the group of the management company.

Inspection and supervision

The CNMV shall inspect and supervise collective investment institutions to make sure that they fulfil all the legal requirements.

Tax aspects

General aspects

Resident shareholders or unitholders of these entities do not have to include in their personal income tax any income until the date these entities distribute their profits, or the date on which the interest owned is transferred by the shareholder or unitholder.

Dividends and profits distributed by these entities do not give any right to apply to its resident shareholders or unitholders any credit to avoid double taxation.

Real estate investment companies

Real estate investment companies, the exclusive social purpose of which is investment in urban real estate to be leased, are eligible for a low income tax rate of 1%, if all the regulatory and tax requirements are met.

Real estate funds

The main differences between real estate funds and real estate investment companies are discussed above under the section "*Financial investments in Spanish real estate*/*Legal aspects*". These funds are taxed in basically the same manner as real estate investment companies.

Mortgage securitisation funds

Mortgage securitisation funds are taxed following the standard income tax regime with the exception that interest-capping rule is not applicable to these funds. In addition, income received by the funds is exempt from withholding tax.

Spanish REIT: *sociedades anónimas cotizadas de inversión en el mercado inmobiliario* (SOCIMI)

Legal form and capital requirements

The only legal form that is permissible for a SOCIMI is a Spanish private limited company (*sociedad anónima*). The nominal capital of a SOCIMI must amount to at least 5 million EUR. There is no maximum threshold for external debt.

Listing requirements

SOCIMIs must be listed on an organised stock market in Spain, the EU, the EEA, or in other countries with an effective tax information exchange with Spain.

Listing is also possible on a multilateral trading system in Spain, the EU or the EEA.

Restrictions on investors

Minimum number of investors

There are no specific provisions for SOCIMI.

Pursuant to the corresponding Stock Exchange regulations in Spain, a listed entity must have at least 100 shareholders with an interest lower than 25%, a minimum 25% free float being standard practice.

In the case of the Spanish multilateral trading system (called MAB) shareholders holding less than 5% of the share capital each must hold at least (a) shares with 2 million EUR of market value, or (b) 25% of the share capital. However, a minimum number of minority shareholders is required by the MAB in practice.

Restrictions on non-resident investors

There are no specific restrictions on non-resident investors.

Asset/Income/Activity tests

The primary corporate activity of the SOCIMI must be the following:

- the acquisition and development of urban real estate for lease, including the refurbishment of buildings;
- the holding of shares in other SOCIMIs or in foreign companies with the same corporate activity and similar dividend distribution requirements as SOCIMIs;
- the holding of shares in Spanish or foreign companies with the same corporate activity, dividend distribution obligations, asset and income tests as SOCIMIs; and
- the holding of shares or units in Spanish regulated real estate collective investment institutions.

At least 80% of the value of the assets must consist of qualifying real estate assets and shares.

In addition, at least 80% of earnings, exclusive of capital gains, must relate to rents and dividends from qualifying assets and shares.

Qualifying assets and shares must be held for a minimum period of three years.

Distribution requirements

The SOCIMI is required to distribute the following amounts once all the corporate law obligations are met:

- 100% of profits derived from dividends received from other SOCIMIs, foreign REITs, qualifying subsidiaries and collective investment institutions.
- At least 50% of capital gains derived from qualifying real estate assets and shares. The remaining gain shall be reinvested within a three-year period or fully distributed once the three-year period has elapsed and no reinvestment has been made; and
- At least 80% of profits derived from income other than dividends and capital gains, ie, including rental income and ancillary activities.

Distribution of dividends shall be agreed within the six-month period following the end of the financial year and be paid within the month following the date of the distribution agreement.

Tax treatment at SOCIMI level

The SOCIMI must be a tax resident in Spain. The SOCIMI is subject to Spanish corporate income tax at 0%.

However, income and capital gains derived from investments which do not respect the 3-year holding period will be taxable at the level of the SOCIMI at the standard corporate income tax rate.

The qualifying subsidiaries whose share capital is fully owned by one or more SOCIMIs may benefit from this tax regime.

In addition, Spanish subsidiaries of qualifying foreign vehicles, including REITs, listed in the EU or EEA are eligible for the SOCIMI regime for their Spanish rental income (the so-called “non-listed SOCIMI”).

Delisting, waiver of the regime, substantial non-compliance of reporting information, or dividend distribution obligations, or any other requirements will result in removal from the SOCIMI regime and a three-year ban to opting again for the REIT regime.

On the other hand, the SOCIMI will be required to pay a 19% “special tax” on dividends distributed to shareholders holding an interest of at least 5% that are either tax exempt or subject to an effective tax rate below 10%. Any withholding tax shall be considered for these purposes. This special tax will not be due if the recipient of the dividends is a foreign REIT itself or a qualifying foreign entity as long as those dividends are subject to a minimum effective tax rate of 10% at the level of the shareholders holding 5% or more of the foreign vehicle. The investor taxation of at least 10% must be communicated to the SOCIMI in order to avoid the special tax.

Withholding tax on distributions

Dividend distributions by the SOCIMI, both to residents and non-residents, are subject to general withholding tax rules and applicable treaty rates.

Tax treatment at the investor level

Resident investors

Individual investors
Dividends derived from SOCIMI shares are subject to general personal income tax rules, with no recourse to domestic exemptions.

Capital gains derived from the disposal of SOCIMI shares are subject to general personal income tax rules.

Corporate investors
Dividends are subject in their entirety to corporate income tax at the general rate 25% with no recourse to the domestic participation-exemption regime.

Capital gains derived from the disposal of SOCIMI shares shall be subject to the general income rate 25% with no recourse to the domestic participation-exemption regime.

Non-resident investors

Individuals and corporate investors without a Spanish permanent establishment
Dividends and capital gains are subject to general rules for non-residents and tax treaties and with no recourse to domestic exemptions.

However, capital gains derived from the disposal of shares in a SOCIMI listed in a Spanish official market are tax exempt in Spain if the non-resident shareholder holds less than 5% of the share capital.

Individuals and corporate investors with a Spanish permanent establishment
Dividends and capital gains are subject to the same rules described above for resident corporate shareholders.

Transition to SOCIMI/Tax privileges

There is no entry tax charge established for the transition to the SOCIMI regime.

However, capital gains obtained by a SOCIMI corresponding to assets held prior to the election would be taxable only for the portion of gains allocated into the pre-SOCIMI holding period.

Applicants can opt for the SOCIMI regime by notifying the Tax Administration before the beginning of the last quarter of the tax period. The regime applies retroactively from the start of the financial year in which the SOCIMI has validly applied for this tax regime.

The law grants a two-year period in order to meet certain REIT requirements, including the listing, during which the SOCIMI is taxed at 0%.

Transfer tax and stamp duty benefits may be of application in connection with the acquisition of residential for lease.

Restructurings aiming at the incorporation of a SOCIMI or the conversion of existing entities into a SOCIMI are deemed as business driven for the purposes of the tax neutrality regime for corporate reorganisations.

Financing the acquisition of Spanish property: Capital contribution and dividends

Legal aspects

Minimum share capital

One of the main differences between an S.L. and an S.A. is the minimum share capital required for their incorporation. For an S.A., the requirement is 60,000 EUR and minimum 25% paid up of each share. For an S.L., the requirement is 3,000 EUR and the 100% paid up of each share.

Minimum debt/Equity ratio

When losses reduce the net worth of an S.A. below two-thirds of the share capital at the end of two consecutive fiscal years, the company is obligated to reduce the share capital. This rule does not apply to an S.L.

When the losses reduce the net worth of the company – either an S.A. or an S.L. – below half of the share capital, the company is obligated to be winded up and liquidated, unless other measures, such as capital increase/decrease, or shareholders contributions are taken to recover the net worth of the company.

Tax aspects

Capital duties

The incorporation of a Spanish subsidiary is exempt from capital tax.

Dividends

Regarding the distribution of dividends, 19% of the gross amount should be withheld when paying them to a Spanish resident company or a company resident outside of the EU, in a country that has not concluded a double taxation treaty with Spain.

Otherwise, the applicable treaty should be consulted in order to determine the withholding tax rate applicable.

If dividends are paid to a company resident in a member country of the EU, and the company owns a direct stake of at least 5% in the capital of the subsidiary, and has one year of seniority, the provisions of the EU Parent-Subsidiary Directive apply. Because of this Directive there is no withholding on the dividends, provided the following conditions are met:

- Both companies are subject and not exempt from direct taxation in the pertinent country of residence.
- The profit distribution is not the consequence of the liquidation of the subsidiary.
- Both companies take one of the forms provided in the Appendix to the EU Directive.
- The anti-abuse provision of the Spanish EU parent subsidiary regime is overcome.

The period of one year of previous seniority may be met if after that date the shareholder maintains the stake for a period of one year.

Debenture and interest

Legal aspects

The mortgage and other guarantees

The mortgage is a in rem right granted by way of guaranty the payment of a specific loan. The mortgage has to be duly drafted before a Public Notary and registered at the Land Registry in order to be duly constituted.

Spanish Law contemplates a special procedure for the foreclosure of the mortgage throughout a public tender granted before a Notary Public. In case that such an auction does not concur bidders, or its bids do not cover a certain percentage of the mortgage debt, the creditor can be the new owner of the plot in approximately no more than one year. In case that other bids are made during the tender procedure, the highest bidder will become the new owner.

There is also a specific Court proceeding that may last between one and two years, depending on the court.

Tax aspects

Income tax

Interest tax deductibility: Transfer pricing

Assuming that loans are granted at “arm’s length” basis, the deductibility of interest depends on the way the investment in Spain is to be made.

In the case of direct investments, interest paid on loans taken out to acquire property, would be deductible as long as they are directly related to the income obtained in Spain and the taxpayer can provide supporting evidence that this is the case.

In the case of investments through a PE or Spanish subsidiary, interest paid by virtue of a loan agreement contracted for the acquisition of real estate is, for corporate tax purposes, in principle fully deductible, provided that the parties met the “arm’s length” principle. However, the PE cannot deduct interest paid to its foreign head office, except under a provision of a tax treaty that may allow such deduction.

Furthermore, when interest is paid to any of those countries or entities considered as a tax haven for Spanish tax purposes, deductibility depends on the proof that the loan is needed for the activity, and that the conditions established respect the ”arm’s length” basis rules.

Transfer pricing documentation regulations shall be observed.

Withholding tax on interest

Interest payments made by a Spanish debtor – be it a company or PE – to a non-resident in consideration of a loan or current account is, in principle, subject to a 19% withholding tax, unless provided otherwise by a tax treaty. In this case the tax rate generally ranges between 0% and 10%. However, Spanish domestic law provides for a withholding tax exemption on interest paid if the lender is an EU entity without the involvement of a PE. However, beneficial ownership must be considered. A certificate of tax residence in the EU must be provided by the lender to the Spanish payer of the interest in order to avoid the withholding on the payments.

Financial expenses-capping rule

A financial expenses–capping rule has replaced the Spanish thin capitalisation provisions with effects to financial years starting on or after 1 January 2012.

The financial expenses-capping rule will limit tax relief for net financial expense to 30% of the operating profit.

The key points of this new rule are as follows:

- The restriction applies to any debt, including intra-group and third-party debt.
- The basis of the 30% limitation is applied to the accounting operating profit after deducting (i) depreciation of fixed assets, (ii) subsidies for non-financial assets and others, (iii) impairment and transfer of fixed assets, and adding (iv) financial income from certain equity instruments.
- The net financial expense of the year up to 1 million EUR shall be treated as tax deductible. This means that the 30% capping only applies to amounts exceeding the 1 million EUR threshold.
- The 1 million EUR minimum threshold should be reduced proportionately for tax periods of less than 12 months.
- Financial expenses disallowed can be carried forward without temporary limitations, increasing the interest expense in the subsequent years, which will be subject to the 30% limit.
- If financial expenses do not reach the 30% breakdown, the difference may be carried forward to the following five years for tax deductibility purposes.
- The financial expense capping-rule will not be applicable to banks and insurance entities.
- This new rule does not preclude the application of the transfer pricing provisions to related party transactions.
- The law establishes specific provisions for tax unities.
- The limitation is not applicable in the period when the entity is extinguished.

On the other hand, financial expenses derived from intra-group debt used to fund the acquisition of interests in entities from other group companies, or for equity contributions to group entities, will not be treated as tax deductible unless such transactions are business driven.

Profit participating loans

Profit participating loans may be considered a type of subordinated loans, which are those by virtue of which the creditor expressly waives its priority in rank in favour of other creditors. These types of loans will be deemed as accounting net worth regarding capital decreases and winding-up of companies for the purposes of the mercantile legislation.

According to Royal Decree Law of 7 June 1996, profit participating loans must necessarily have the following features:

- The loans must provide the investor with a variable interest determined on the evolution of the activity of the business. The criteria to determine the said evolution may be profits, level of revenues, net equity of the borrower or any other criteria established by the parties linked with the evolution of the borrower business activity.
- Early repayment can be penalised if agreed to by the parties. On the other hand, the anticipated amortisation of the participating loan will require an equivalent increase of the net equity of the company.
- Spanish company law subordinates creditors of participating loans to all common creditors, except the shareholders of the company when such company is liquidated.

Additionally, it is essential that there exists an obligation for the borrower to repay the investor the funds granted, in order to determine the loan's nature as debt and not as equity.

In the case of profit participating loans granted by a non-resident-related entity, financial expenses capping rules would also apply, and the fixed and variable interest paid by the Spanish subsidiary or PE should meet the "arm's length" principles to preserve the interest's deductibility and be duly documented.

However, it must be noted that interest deriving from profit-participating loans granted by any entity of the corporate group will not be tax deductible for corporate tax purpose.

On the other hand, it must be noted that, participating loans are considered as equity for purposes of debt/equity balance. Therefore, they represent a useful tool to rebalance debt/equity ratios for commercial purposes.

Subordinated loans

Although commonly used by banks and credit entities, loans referred to any other particular issue, different to the evolution of the business as a whole, are not expressly regulated in Spanish legislation. Therefore, we should attend standard rules for its deductibility (market rates, financial expenses capping rules, tax-havens regime, transfer pricing).

Stamp duty on real estate mortgages

When a mortgage loan is entered into in order to finance property, a stamp duty is levied at a rate of 0.5% to 1.5%. No stamp duty is levied on any other kind of loans, even participating loans or any other kind of debt instrumented in securities, provided that they are not secured by a mortgage.

Real estate financial leasing

Legal aspects

Leasing contracts are briefly regulated by the Law 10/2014 of 26 June (*Ley de ordenación, supervisión y solvencia de entidades de crédito*), which defines these types of contracts. These types of contracts can be used both for personal property and real estate.

According to this type of contract, the financial leasing entity owner of the premises or plot leases it to another person and gives that person an option to buy at the end of the term of the lease. The contract discounts from the final price the amounts already paid by the lessee in cases where the lessee exercises its option to buy.

This type of contract can be recorded at the Land Registry to have validity before third parties.

The accounting treatment for the lessee of a lease with a purchase option will depend on whether the purchase option is reasonably expected to be executed or not, according to the economic conditions of the lease contract.

Only when the purchase option is reasonably expected to be executed by the lessee, will the special accounting rules applicable to the lessee coincide with what is commonly known as a finance lease.

Otherwise, if the purchase option is not reasonably expected to be exercised by the lessee according to the economic substance of the agreement, the lease will have to be registered by the lessee according to the rules corresponding to standard renting.

Under Spanish corporate tax legislation, in a leaseback operation the transferred asset will continue under the same depreciation regime as before the transfer, as if the transfer had not taken place.

Tax aspects

Income tax

Resident or non-resident with a Spanish PE

The part of the leasing instalments which correspond to the recovery of the cost of the goods will be considered as a tax-deductible expense for the lessee, except if the contract covers lands, sites or other non-depreciable assets. The lessee will likewise obtain tax relief from the financial charge paid to the lessor entity.

The amount of this tax deduction may not exceed the result of applying twice the straight-line depreciation coefficient that corresponds to the leased assets in accordance with the official approved depreciation tables. Accordingly, the leasing tax regime provides an accelerated depreciation regime, consisting of double the standard depreciation. For companies with a medium or reduced size, the accelerated regime may rise to triple the standard depreciation corresponding to the asset.

In order to enjoy this regime, the leasing contract must fulfil the following requirements:

- The leasing contract must be carried out with a leasing financial entity as defined in the Law of Discipline and Control of Credit Entities.
- The leasing contract must have a minimum term of two years when they cover movable goods, and of ten years when they cover real estate or industrial establishments.
- The financial leasing instalments must be expressed in the respective contracts in such a way that they differentiate between the part that corresponds to recovery of the cost (excluding the purchase option) by the lessor entity and the financial charge required by the said entity.
- The annual amount of the part of the leasing instalments corresponding to recovery of the cost must remain equal or increase throughout the contractual period.

Non-residents without a Spanish PE

Payments made by a Spanish resident lessee to a non-resident lessor without a PE in Spain, for the lease of real property, under both operating and finance leases, will be subject to withholding tax in Spain. This withholding tax is at the general rate of 24% established for non-residents. However, the tax rate for EU residents would be 19%.

However, if the lessor were deemed to have a PE in Spain in connection with the leasing activity, the above-mentioned payments would be subject to the general corporate income tax rate of 25%, corresponding to resident taxpayers.

VAT

As a general rule, any leasing of assets – residential excluded – carried out by VAT taxpayers will be subject to VAT at the general rate of 21%. In this case, the lessor entity will be required to charge VAT to the buyer.

VAT will accrue when the periodic instalments became binding, on the amount of the instalment in question.

Managing Spanish real estate

Corporate income tax: Resident entities and non-residents with a PE

Resident entities and non-resident entities with a PE are taxed, in general terms, at a 25% rate on the net income, which is calculated following the principles of the Spanish accounting plan.

In particular, the following expenses are tax-deductible if properly documented:

- interest expenses, provided that the financial expenses-capping and transfer pricing rules are respected (PE cannot deduct interest paid to its foreign head office);
- operating expenses;

- maintenance expenses;
- property management expense;
- property valuation fees;
- legal fees;
- tax advice;
- audit fees;
- management fees, subject to transfer pricing requirements; and
- capitalisation of expenses and interest incurred in acquiring the property.

Other expenses in addition to the acquisition price, such as those arising from demolition, insurance, installations, etc, incurred prior to the entry in operating conditions of the property, can be considered part of the acquisition price, and amortised, instead of considered expenses.

Furthermore, interest related to the acquisition of the real estate, accrued up to the same moment, can also be capitalised.

Tax depreciation regime of real estate assets

With the exception of land, and the capitalised expenses related to land, most tangible and intangible fixed assets are depreciable for Spanish resident companies, foreign companies acting under a PE, and both national and foreign individual entrepreneurs. However, the depreciation rules as described below do not apply to property held as inventory.

The tax depreciation method generally used for building depreciation is the straight-line method. The original acquisition costs, ie, the acquisition cost itself plus related expenses, such as registration duties, brokerage fees, notary's fees, architect's fees, etc are the basis for depreciation. As a general rule, 2% is the straight-line depreciation rate acceptable for commercial properties such as office buildings; 3% for industrial properties. This rate can be doubled if the property is acquired already used, or other rates can be used if an agreement is reached with the tax authorities. However, if it can be substantiated that the useful life of the property is shorter, a higher depreciation rate may be applied. This is normally achieved by means of special depreciation plans to be agreed with the Spanish Revenue.

Plants and machinery can be depreciated at a higher rate, where they can be considered as a differentiated part of the immovable property. These items are considered as such when they can be separated from the property with no major alteration of the latter.

Costs and expenses derived from the acquisition, such as transfer tax, or notary fees, for instance, can be, generally, computed as acquisition value, and therefore depreciated as well.

Impairments of real estate assets

When the market value of a property, regardless of whether it is considered as a fixed asset or inventory, falls below its acquisition price, or production cost, the accounting value can be adjusted with the pertinent provision, if reversible.

However accounting impairments in value of the immovable properties are not tax deductible for corporate income tax purposes. Notwithstanding, impairments in value of real estate assets held and registered as inventories may be tax deductible.

Personal income tax

As mentioned previously, income derived from the letting of property in Spain held by individuals is subject to taxation in Spain, but the basis depends on the consideration of individuals as resident or non-resident in Spain.

Income from immovable property obtained by a resident individual will be subject to Spanish personal income tax at a maximum progressive rate of 45%.

In the case that real estate income, could be considered as business earnings, corporate tax rules should be applicable.

Withholding tax on rents

Income obtained from the lease of urban property is subject to withholding, in principle, and the lessees are required to make the relevant withholding of 19% from the rent paid. However, the lessee will not be required to withhold any amounts from this income if any of the following requirements are met:

- The annual rent paid by the lessee to the lessor does not exceed 900 EUR (VAT excluded).
- The rent is paid by a company for the renting of a dwelling at the disposal of its employees.
- The lessor is obliged to pay a business tax, as explained below, on professional and business activities. This would be the case when the cadastral value of the leased property is equal to or greater than 601,012.10 EUR. In this case, the lessor must prove such circumstances to the lessee through the relevant certificate.
- The rents are due to financial leasing contracts of urban properties according to the Law of Discipline and Intervention of Credit Entities.

Non-resident entities without a PE

Non-resident entities without a PE are taxed, accrual by accrual, at a 24% rate on certain net income. However, the tax rate for EU residents is 19%.

VAT

The letting, financial leasing and granting of surface or rights in rem on commercial property, such as office buildings, shopping centres, business facilities, etc is subject to Spanish VAT at the general rate of 21%.

However, the letting of property for housing purposes is exempt from VAT.

In cases where a VAT taxpayer lets different types of property so that they carry out both VAT-able and VAT-exempt letting of property, the partial deduction rule regime will be applicable.

Spanish VAT due on supplies and services rendered by non-established VAT taxpayers to an established Spanish VAT taxpayer is levied upon the established Spanish VAT taxpayer recipient of the supply or service. This is the reverse charge rule.

Business tax

Any business developed in Spain is subject to business tax, levied on a yearly basis. The business tax cost will depend on the specific activity carried out by taxpayers. Office/commercial facilities renting activity tax charge is 0.10% of the cadastral value of the leased surface within the national territory. If the total cadastral value is lower than 601,012.10 EUR, no business tax shall be charged under this concept.

Taxpayers with an annual turnover under 1 million EUR (according to the last corporate income tax return filed) and individuals are tax-exempt. In addition, the first two years of activity are also exempt.

Business activity tax is deductible for corporate tax purposes.

Real estate tax

Real estate tax is levied on an annual basis and the tax rates may range from 0.4% to 1.135%, applicable to the cadastral value of urban properties, and 0.3% to 0.9%, applicable to the cadastral value of non-urban properties. However, such rates are increased or decreased by the local authorities, depending on the specific location of the property.

The taxpayer of this tax is the owner. Notwithstanding the above, this tax is commonly charged to the tenant if so agreed. Real estate tax is deductible for corporate tax purposes.

Special tax on real estate owned by non-residents

A 3% tax is levied on a yearly basis on the cadastral value of real estate owned by residents in tax havens. This value is reviewed periodically.

However, this tax is not levied under the following certain circumstances:

- when the properties are owned by listed companies on official secondary stock markets;
- when the properties are owned by foreign states, public institutions or international bodies;

- when the properties are owned by non-resident entities that develop in Spain an economic exploitation different from the mere leasing of the real estate.

Transferring real estate

Legal aspects

The transfer of a real estate property by a non-resident

The transfer of real estate property by a non-resident needs to meet the same conditions and formal requirements as a transfer by a resident.

These types of contracts must include all legal requirements established in the Civil Code for the transfer of property.

Transfer of ownership: simple contract do not transfer the property of real estate. Two elements are required: title (contract, public deed, etc) and the transfer of possession (modo) which can be made in a symbolic way. The notarisation of the transaction implies the transfer of ownership unless parties agree on the contrary.

Registration at the Land Registry is not compulsory, but it is advisable.

According to the Royal Decree 9/2005 of 14 January 2005, concerning soil pollution, when the transfer of a property (or the transfer of a right over a property) is granted by means of a public deed and potentially polluting activities have taken place in the transferred property, the owners will be obliged to declare this fact in such deed.

Likewise, when an administrative decision has been adopted stating that a specific property is polluted, this decision will have to be stated in the Land Registry.

On the other hand, pursuant to the legislation regarding the prevention of money-laundering activities, the means of payment and the data concerning the origin of the funds (account number, cheque, etc) shall be stated in the Public Deed and a proved copy of the bank cheque or accreditation of the money transfer (or any other kind of money order) will be enclosed to the deed.

The transfer of shares in a non-resident real estate company

The transfer of shares in a non-resident real estate company does not imply the transfer of real estate assets, because there is only a change of partners. For this reason, it is not necessary to celebrate in Spain a private contract, or to grant a public deed of transfer of real estate property. The owner of the properties recorded at the Spanish Land Registry will be the same after the purchase of shares of the real estate company.

Tax aspects

Capital gains taxation

Resident entities

Capital gains realised by a Spanish resident company on the transfer of Spanish property are subject to Spanish corporate tax. Capital losses realised on the transfer are fully deductible. The capital gain or loss realised on the disposal of the property is calculated as the proceeds less the tax book value of the property, ie, historic cost minus tax depreciation.

Currently tax loss can be carry-forward without time limitations.

The capital gains derived from the transfer is subject at the standard rate of 25%.

Resident individuals

Under Spanish personal income tax rules, the amount of the capital gains or losses shall be determined by the difference between the acquisition (less depreciations) and transfer values, in the case of capital gains stemming from the disposal of real estate.

Capital gains obtained in the transfer of real property are taxed at different rates have in tranches: 19% for gains up to 6,000 EUR, 21% between 6,000 EUR to 44,000 EUR, 23% for gains above 50,000 EUR.

Non-resident entities and individuals

Transfers of Spanish properties by a non-resident entity without a PE are subject to a 19% tax on the capital gain.

If a PE exists, capital gains would be added to the non-resident income taxable base, and netted against expenses and capital losses, if any.

Under Spanish domestic legislation, capital gains derived from the disposal of Spanish companies, the main assets of which consist of real estate, are taxable in Spain at a 19% rate. However, under certain tax treaties, such taxation can be avoided.

This treatment is also applicable to the sale of participation on real estate funds or companies.

Special regime for mergers, spin-offs, contribution of assets and exchange of securities

There is a special tax-free regime available when transferring properties, or real estate companies, as a result of some corporate operations, such as mergers, spin-offs, contribution of assets and exchange of securities.

For these cases, it is required in general terms that the acquiring entity is a Spanish-resident entity, and it is forcedly to be notified to the Spanish tax authorities.

It should be noted that Spanish law goes further than EU disposals regarding neutrality in corporate operations and grants the regime also to mere contributions in kind made by a non-resident to a Spanish-resident company.

Tax neutrality regime requires corporate restructuring to be business motivated.

Special 3% withholding on real estate transfers

When a non-resident without a PE in Spain is transferring a property located in Spain, the acquirer, regardless of whether they are resident or not, will become obliged to withhold 3% of the price, on the account of the transferor's income tax.

This 3% withholding does not apply on the transfer of the shares of Spanish real estate companies made by non-resident shareholders.

VAT/Real estate transfer tax

The same comments included in the section "*Direct purchase of assets*/*Tax aspects*" are applicable here in connection with the indirect taxation of assets.

Revision period for VAT deduction regarding real estate assets

Under Spanish VAT legislation, a property is subject to a so-called revision period. The revision period is ten years, ie, the calendar year in which the property is put into use and the subsequent nine calendar years. In the year in which the property is put into use, the VAT will in principle be recoverable according to the ratio between the turnover from VAT-able supplies and the total turnover of the taxpayer.

At the end of each following year a comparison must be made between that year's ratio and the ratio of the acquisition year. If the ratios differ, either additional VAT payment must be made, or a VAT refund will be received by the owner of the property. However, if the ratios differ by 10% or less, no additional payments will be made. When property is transferred during the revision period, a VAT adjustment may be required. For that purpose, 10% of the original VAT paid is notionally allocated to each year of the revision period.

Regarding the VAT consequences of the transfer of the property during the revision period, the following rules apply:

- If the transfer is not subject to VAT (with the exception of the transfer of a going concern), then a legal fiction assumes that the property has only been used by the seller for tax-exempt activities during the remaining part of the revision period. The input VAT, at an amount of 10% per year, allocated to this remaining period, cannot be recovered by the seller. If this VAT has already been recovered by the seller in previous years, a one-time adjustment payment must be made by the seller to the tax authorities for the remaining part of the ten-year period.
- If the transfer is subject to VAT, then a legal fiction assumes that the property has been used by the seller for taxable activities during the remaining part of the revision period. The input VAT, at an amount of 10% per year, allocated to this period can be fully recovered by the seller.

Regarding the ten-year revision period, a new computing will start for the buyer of the property, following the VAT-able transfer of a property.

Municipal tax on increase in value of urban land

This local tax will accrue upon the transfer of urban land. The taxpayer is the seller. The economic consequences of this tax could be relevant, depending on the date of acquisition of the land transferred.

The maximum tax rate will be 30%, depending on the municipality where the real estate is located. This tax rate is applicable on the deemed increase in value calculated on the cadastral value of the land taking into account the coefficients included in the tax ordinances. The tax on increase of value of urban land is deductible for corporate tax purposes.

Sale of shares in Spanish resident entities

Under Spanish domestic legislation, capital gains obtained by non-residents from the disposal of shares of Spanish companies for which their main assets consist of real estate are taxable in Spain at a 19% rate. However, under certain tax treaties such taxation can be avoided.

Conclusion

As in any other investment, the fixing of an optimal investment structure for real estate acquisition, exploitation or transfer will depend on the specific objectives of each investor.

Before investing in Spanish real estate, it is highly advisable for the investor to check the burdens on the property, and whether it is eligible for the use towards which it is intended.

Obviously, the optimal solution might vary from passive to active investments, from long-term to short-term expectations, or even depending on the residence of the investor or the financial tools available.

Apart from direct taxation considerations, some other very different aspects should be borne in mind prior to investing in Spanish property, such as the following:

- VAT recovery;
- possibility of option to VAT if VAT exempted;
- transfer tax;
- taxation on share deals, when acquiring or transferring;
- financial expenses capping rule;
- transfer pricing; and
- repatriation of funds.

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Real Estate Going Global

Sweden

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

General

A foreign corporate investor may invest in Swedish property directly or through a local company. The local company can either be a limited liability company (*aktiebolag*, or AB) or a partnership (*handelsbolag*, or HB/ *kommanditbolag*, or KB). Foreign investors frequently invest in Swedish property through either a resident or a non-resident holding company structure, eg, a foreign or domestic holding company owning shares in one or more subsidiary companies.

Competitive corporate taxes

The Swedish corporate income tax rate is 21.4% (20.6% in 2021). The effective tax rate may be lower due to the possibility of deferring taxation on profit. Computation of taxable income is based on statutory accounts, to which certain adjustments are made for tax purposes. Interest expenses on funds borrowed from, banks or affiliated companies (see below for interest cost deduction limitations), and property-related expenses are tax-deductible for resident and non-resident companies and partnerships owning Swedish property.

There are currently no thin capitalisation rules in Sweden. However, Sweden has imposed interest stripping limitations as of 1 January 2013. In addition, EBITDA-based interest limitations were enforced as from 1 January 2019 (for further information, please see below).

Group consolidation

Each company within a group constitutes a separate taxable entity. Note that a company group is not taxed on a consolidated level. However, the group relationship is taken into account in various ways such as the special tax regime concerning group contributions. Group contributions constitute of a value transfer between group companies that is deductible for the transferor and taxable for the transferee. Such transfers are reflected as year-end accruals in the annual accounts of both companies and are executed by way of transfer of funds. The most important condition for qualifying for exchanging group contributions is a common ownership exceeding 90% that has existed during the entire fiscal year, or since the subsidiary was originally incorporated (should incorporation have taken place in the income year during which the group contribution is passed). An off-the-shelf company has, in the same way as for a newly incorporated company, the possibility to exchange group contribution in the income year in which it has been acquired.

Tax losses carried forward

Tax losses in Swedish companies can be carried forward indefinitely and offset with future profits and group contributions (see above). Losses may not be carried back.

When a company with tax losses carried forward is subject to a change of control, these tax losses may be forfeited depending on the price paid for the shares. A change of control occurs when a company acquires the “deciding influence” of another company. Tax losses carried forward pre-acquisition can be carried forward only to the extent that the losses do not exceed 200% of the price paid for the shares, ie, tax losses carried forward exceeding 200% of the price paid for the shares are forfeited. Any capital contributions made to the company with tax losses, or another group company that is part of the group before and after the change of control, in the year of acquisition and the two preceding years, should reduce the acquisition cost when calculating the 200% ratio.

Tax losses carried forward which are not forfeited are restricted for five financial years following the year of the change of control (eg, 2020) and can thus not be set off against group contributions until the sixth year following the year of the change of control, ie, are available for set off in year 2026. However, the restricted tax losses carried forward may be utilised against profits in the company with the tax losses carried forward and companies that before the change of control were able to exchange group contributions. Note that this restriction is also in relation to companies acquired into the group of which the company with tax losses carried forward is a part of.

Tax losses carried forward in a company subject to a merger are subject to two limitations within a merger. One is that tax losses carried forward are forfeited to the extent they exceed 200% of the price paid for the shares (see above). However, should the acquiring company have the deciding influence of the transferred company prior to

the merger, this first limitation should not apply. The other limitation is that to the extent the tax losses carried forward are not forfeited in the transferred company and to the extent there are tax losses carried forward in the acquiring company, both these tax losses carried forward will be restricted for five years following the year of the merger and during this period, cannot be set off against group contributions nor against profits of the acquiring company (surviving company) post-merger until the sixth year following the year of the change of ownership, ie, the tax losses carried forward in a company part of a merger in 2020 are available for set off in the year 2026 .

Tax allocation reserve

Swedish tax legislation offers a general option to set up a reserve, which can best be described as a tax allocation reserve, in addition to an excess depreciation reserve. This option is intended to allow companies the possibility to carry back losses to offset previous years' profits, since the Swedish tax legislation does not contain a specific loss carry back provision. A company may allocate 25% of the tax adjusted result, calculated prior to the allocation. A particular year's allocation to the reserve can be released at the discretion of the company, eg, to cover a net operating loss. The reserve must however be released to taxable income no later than in the sixth taxation year after the taxation year when it was added to the reserve. As a result, a company using this option will on its balance sheet have an untaxed income reserve, equal to the sum of 25% of each of the last six years' tax adjusted result calculated prior to the allocation.

On the allocations made an interest is calculated which constitutes a taxable income. The interest is the government borrowing interest in November the year prior to calculating the interest. The interest is calculated on allocations held at the beginning of the tax year.

Depreciation

Property should be carried at its historical cost. In Sweden, an annual depreciation rate of between 2% and 5% is allowed for tax purposes in respect of buildings, excluding land. The depreciation rate for tax purposes does not have to correspond with the book depreciation.

As of 1 January 2019, an additional deduction possibility, a so-called "primary deduction", has been introduced for rental buildings regarding costs incurred in new construction, in making additions to existing buildings and in the reconstruction of buildings. For these costs, a depreciation can be made with an additional 2% per year the first six years from the time the construction work was completed. If a rental building is acquired by way of a share deal within six years from completion, the purchaser shall make a primary deduction for the remaining part of the six-year period, which is then calculated based on the acquisition cost. However, it is only possible to acquire the right to primary deduction for cost incurred in new constructions and not cost attributable to additions or reconstructions of existing rental buildings.

Interest cost deduction limitation rules

Sweden has two interest deduction limitation rules:

i) a strict deductibility limitation on interest expenses on loans to affiliated companies but with explicit exemption (the "targeted rule"); and

ii) a general rule for so-called negative net interest (the "general rule").

Any additional expenses or one-off fees related to the repayment of the debt may be considered as interest and thus also subject to the interest deduction limitation rules.

For loans in a foreign currency, any exchange losses can be seen as an interest cost and exchange gains as an interest income if the foreign exchange (FX) risk has been hedged by way of a financial instrument with regard to the general rule.

The targeted rule

According to the targeted rule interest expenses to a group company is not deductible if none of the exemptions below are applicable. Companies are considered to be in a group if a company has essential control over the other.

The exemptions are as follows, ie, the interest on intra group loans are deductible if:

i) the final recipient of the interest is domiciled within the European Economic Area (EEA);

ii) the final recipient of the interest is domiciled outside of the EEA, but in a state with which Sweden has entered into a tax treaty and the recipient is subject to the rules of the tax treaty; or

iii) the final recipient of the interest is taxed for the interest income at a minimum effective tax rate of at least 10% according to the tax legislation in the state in which the recipient is domiciled (should the recipient only be taxed for that income).

Note that even if one or several of the circumstances are fulfilled, the interest is not deductible if the debt solely or almost solely (90%-100%) has been put in place in order to receive a substantial tax benefit.

If the interest expenses on intra group loans are deductible according to the targeted rule, then the interest expenses would in addition be subject to the general rule.

The general rule

The general interest deduction limitation rule is applicable on both internal and external loans and the right to deduct any negative net interest will be based on a so-called EBITDA rule or a simplification rule ("safe harbour" rule). The negative net interest is the difference between interest income and interest expenses when the interest expenses are larger than the interest income. Companies qualifying to give group contributions to each other can offset negative net interest in one company with positive net interest in the other company with an amount corresponding to the positive net interest. Note that interest costs that have been considered as non-deductible according to the targeted interest deduction rule, should not be included when calculating the net interest.

The EBITDA rule means that a company's negative net interest is deductible up to 30% of the tax adjusted EBITDA result (earnings before interest, taxes, depreciation, and amortisation).

The simplification rule, states that it will be possible to deduct negative net interest up to a maximum of 5m Swedish kronor (SEK). For affiliated companies the total deductions for negative net interest may not exceed 5m SEK if any of the companies makes use of this rule.

Negative net interest which is not deductible according to the EBITDA rule can be carried forward during a period of up to six years. Note that negative net interest not deductible according to the simplification rule cannot be carried forward. Furthermore, interest expenses carried forward cannot be used to be offset against positive net interest in another group company.

Withholding tax (WHT)

There is no WHT on interest in Sweden and there is no WHT or branch profits tax applicable to permanent establishments (PEs) operating in Sweden. Dividends distributed by a resident company to a foreign company are, in short, exempt from WHT, if the latter company would be exempt from taxation on received dividends as if it would have been a company resident in Sweden (ie, dividends received on unlisted shares, or if the shares are listed, a participation of at least 10% of the voting power and a holding period of at least 12 months is required). Thus, the foreign company must have the same characteristics as a Swedish company, both in respect of the legal characteristics, eg, such as limited liability for the shareholders, as well as being liable to tax in a similar manner as a Swedish company. Should a company not qualify for the exemption, a 30% WHT applies. However, the WHT rate can be reduced according to a double tax treaty (DTT) concluded between Sweden and the other country.

The implementation of the general anti-abuse rule (GAAR) included in the EU Parent-Subsidiary Directive (the "Directive") could be regarded as one measure to deal with some hybrid mismatch arrangements in connection with base erosion and profit shifting (BEPS), and to some extent to deal with substance requirements relating to treaty shopping. The changes entered into force on 1 January 2016 are as follows:

- The rules regarding the participation exemption are revised resulting in dividends from shares held for business purposes no longer being exempt if the dividend payments are deducted as interest or other in the country where the shares are domiciled. The rule will apply irrespective of which country the dividend payer is domiciled.
- WHT: clarification of the rule regarding the prevention of situations where formally shares being hold at the time of dividend distribution (instead of the "real" beneficial owner). The wording of the rule will be the same as before, but increased focus on the issue is expected.
- It will be possible to apply for an advance ruling with regard to WHT (within four months from the date of the dividend distribution).

When implementing Article 1.2 of the Directive into Swedish law, the Swedish Government stated that the current anti-avoidance provision in the Swedish Coupon Tax Act (the "WHT Act") is sufficient for the implementation in question. However, the anti-avoidance provision should be interpreted in light of Article 1.2 of the Directive.

When interpreting the anti-avoidance provision in light of Article 1.2 of the Directive, it cannot be ruled out that further substance requirements may apply for holding structures. From a domestic Swedish point of view, it is

important to know that no proposals have been presented in which the law is suggested to be amended or applied in this respect, and no guidelines have been issued by the Swedish Tax Agency to that effect.

The Swedish Ministry of Finance referred a proposal regarding a new WHT Act on dividends to replace the current WHT Act. The rules are expected to enter into force on 1 July 2022. For further comments, see section "*Proposed changes regarding withholding tax*" below.

ATAD II

As from 1 January 2020, Sweden has adopted new hybrid regulations. The rules apply to interest deductions as well as deductions of other expenditures. In general, the rules are to cover situations/transactions between affiliated parties, but the rules may also under certain conditions be applicable in other cases where a tax benefit arise. To give some examples, the followings situations are, inter alia, effects of the new rules:

- "Hybrid financial instrument rule" – A company is not allowed to make deductions for expenses paid to a company in accordance with a financial instrument, if the receiving company does not recognise the corresponding income for taxation and the different treatments is due to the legal classification of the instrument. However, no causality does need to exist between the non-inclusion and the different legal classification to deny the tax deduction, ie, the reclassification does not need to be the cause for the non-inclusion (no so-called "origin test"). Only the primary rule from ATAD II has been implemented.
- "Hybrid payer rule" – A company is not allowed to make deductions for expenditure paid to a company, if the receiving company does not recognise the corresponding income for taxation and this is due to a different legal classification of the paying entity. In this case, a causality must exist between the different legal classification and the non-inclusion. Thus, in case of eg, a tax-exempt receiver, the rule should not apply. Only the primary rule has been implemented.
- "Reverse hybrid rule" (hybrid receiver rule) – A company is not allowed to make deductions for expenditure paid to a company, if the receiving company does not recognise the corresponding income for taxation and this is due to a different legal classification of the receiving entity. In this case, a causality must exist between the different legal classification and the non-inclusion. Thus, in case of eg, a tax-exempt receiver, the rule should not apply. Only the primary rule has been implemented.

In addition to the above, there are new rules regarding the following areas:

- "Disregarded branch structure rule", "diverted branch payment rule", "deemed branch payment rule" – In short, these rules refer to mismatches resulting in deduction, but non-inclusion, due to the legal classification of branches/PEs.
- "Imported mismatch rule" – Imported mismatches mean that the effect of a hybrid mismatching that occurs between two different countries are transferred (imported) to third country. For example, a company is not allowed to deduct expenses to a company in a country outside the European Union to the extent the corresponding income can be netted against another deductible cost, which in turn is not included as taxable income, or, the other cost can be deducted twice. This rule does however not apply to the extent any of the other states has sufficient hybrid regulation themselves.
- "Rules regarding double deductions" – These rules limits deduction of expenditures in situations where eg, the same cost is deducted in two different companies, the same cost is deducted by the same company but in two different countries and against different income.

Real estate transfer tax (RETT)

A direct acquisition of the legal title to Swedish property is for legal entities subject to 4.25% RETT. The taxable base for RETT shall be constituted by the either the purchase price or the tax assessment value of the real property (whichever is higher) at the time of the acquisition.

The sale of shares in a property holding company/partnership is not subject to transfer tax.

Value-added tax (VAT)

Sales and permanent letting of properties and premises are generally not subject to VAT. However, there is a possibility to voluntarily register for VAT liability for letting of business premises, provided that the letting refers to delimited areas in the building, the business conducted on the premises is subject to VAT and the premises are let during a permanent time, ie, one year. According to the Swedish Tax Agency´s guidelines (2020) letting of open

spaces (ie, co-working spaces) is regarded as not possible to register for voluntarily VAT liability. A landlord becomes registered by way of issuing an invoice with VAT for the rent.

A voluntary VAT liability implies that the lessor generally has a right to deduct input VAT on investments made in respect of the property and other expenses related to the property.

Property owners and first- and second-line tenants may be granted voluntary VAT liability.

According to the Swedish VAT Act, VAT adjustment documentation should be issued by the seller to the buyer when a property is sold through a direct transfer. Where a property is transferred through the sale of the company holding the property there is no such obligation. The VAT adjustment documentation should eg, include certain information regarding the investments made on the property during the past ten years and information regarding the seller and the buyer.

Adjustments of input VAT should be made if the use of premises where an investment has been made, changes from VATable to non-VATable or vice versa. The VAT adjustment could as a result either imply that the owner of the property is granted additional deductions of VAT or that the owner of the property is liable to repay previously recovered input VAT.

Input VAT attributable to the purchase of a property could as a result be recovered to the extent the property is used in a VATable business. Regarding input VAT pertaining to costs incurred in the process of purchasing a property company, recovery could be possible provided that the acquired company will be part of the buyer's VATable business. The right to deduct input VAT on transaction costs is currently under scrutiny by the Tax Agency.

The Swedish Supreme Administrative Court ruled (on 27 April 2011) that real estate broker's services are VAT-exempt when property is sold via a corporation. The reason for that is that the services supplied relate to the intermediation of shares. The ruling is applicable when the structure of the real estate transaction via a corporation is agreed prior to the sale.

According to the Swedish Tax Agency's guidelines, VAT pertaining to real estate broker's costs incurred when a property is sold, is not deductible. The reason for that is that the real estate broker's services relate to the sale of real estate, which is VAT-exempt.

Property tax

The owner of property is general subject to annual property tax or property fee. The property tax ranges between 0.2% and 2.8% per annum calculated on the tax assessment value. Properties with commercial buildings such as offices, department stores, etc are subject to property tax levied at the rate of 1%.

The company holding the property in the beginning of the calendar year is liable to pay the property tax. The property tax is however normally divided by agreement (ie, either in the property transfer agreement or in the share purchase agreement) between the purchaser and the seller during the acquisition year.

Certain types of properties that qualifies as special units are however exempt from property tax. Such units do not have a tax assessment value.

A property can be assessed as a special unit if the tenants carry out certain types of "business" (services) that relate to eg, cultural practice, sports, healthcare, dental practice, some qualified housing. To the extent the main part of a building (>50%) are used by such qualified tenants, the property should be assessed as a special unit and thus not subject to property tax.

However, there is no distinctive definition of how the main use should be calculated. The rules as such are rather mechanical and to the extent a majority of the property is used for "taxable purposes", ie, not by such qualified tenants, the property should not be a special unit and thus subject to property tax.

DAC 6

The so-called "DAC 6" directive entered into force 25 July 2018. The purpose of this directive is to prevent aggressive tax planning within the EU by increasing the transparency. The Swedish rules entered into force 1 July 2020, but the date of reporting has been deferred to 31 January 2021.

Information on cross-border arrangements must be reported to the tax agency if the arrangement meets certain hallmarks which indicates a risk of tax avoidance. It is mainly the provider of the arrangement that is obliged to report eg, tax advisors, etc. Under certain conditions, the user of the arrangement can be obliged to report it. If the arrangement is not reported in time, sanction fees are to be paid.

Upcoming changes to tax law

ATAD II

Rules against so-called “reversed hybrid mismatch arrangements” are to be introduced to prevent international tax planning. Sweden will implement these into Swedish law and new rules will come into force as of 1 January 2021.

Proposed changes regarding withholding tax

The Swedish Ministry of Finance referred a proposal regarding a new WHT Act on dividends to replace the current WHT Act. The rules are expected to enter into force on 1 July 2022.

According to the new Act, a non-Swedish tax resident (ie, not limited to entities qualifying as a legal person) who is entitled to the dividend at the time of the dividend payment is liable to WHT at the rate of 30%. The taxpayer will still be entitled to a so-called “relief at source” by reference to DTTs directly at the time of distribution under specific conditions.

Under the current rules, tax is withheld when dividends are paid to a person who is considered as entitled to the dividend. According to the proposal, withholding tax should instead be withheld on dividends paid to a person who is the actual recipient of the dividend at the time of the distribution. The so-called “beneficial owner” in the OECD model agreement is proposed to be applied when making the assessment of who is the actual recipient/entitled to the dividend. This will affect eg, securities lending.

It is the company paying the dividend that is liable to withholding the tax. If payment is made to an authorised intermediary, the intermediary should take over the responsibility for withholding, reporting and paying the tax on dividends. Central security depository, registered trustee or management company may be authorised as an intermediary.

The current anti-avoidance rule in the Swedish WHT Act is proposed to be replaced with a new provision in the general Swedish Anti-Tax Avoidance Act. The current anti-avoidance provision is applicable in all situations where an entity receives dividends, provided that the holding of the shares is intended to result in an illegitimate tax advantage for someone else. The current provision has never been used as a substance requirement. However, the proposed new provision seems to be based on the concept of beneficial ownership and other EU anti avoidance regulations. Although, no defined substance requirements have been introduced on the proposal.

The proposed legislation states certain exemptions to withholding tax, mainly to ensure that the Swedish legislations is in accordance with the EU legislation.

- A foreign state or foreign equivalent to a Swedish region, municipality or municipal association is not considered liable to withholding tax.
- If the person entitled to the dividend is a foreign equivalent to a Swedish foundation or other legal person who is not liable to tax, the dividend is exempt from withholding tax.
- A foreign legal person who is liable to WHT may deduct from the dividend costs directly related to this dividend.
- Deferral is granted for the payment of WHT on dividends when the recipient is a foreign legal person with tax losses (in accordance with the rules previously introduced as a result of case of the European Court of Justice.
- No changes to the current rules in taxation of royalties have been proposed and no new rules on WHT on interest payments have been introduced.

Real Estate Investments

Introduction

There are no designated fund vehicles in Swedish practice. Accordingly, there is no specific Swedish tax regime for real estate funds. Swedish real estate funds are normally structured in the legal form of a limited liability company (*aktiebolag*, or AB) or a partnership (*handelsbolag*, or HB/*kommanditbolag*, or KB) either in a pure domestic structure or combined with foreign fund vehicles where the Swedish entities function as holding companies.

Purchase of a real estate company

An AB or HB/KB are the most common alternatives used for investments in Swedish real estate. Most objects available for sale on the market consist of property-owning ABs or HB/KB rather than "naked" real property. The main reason for this setup is that transactions of the real property imply real estate transfer tax at 4.25% of the higher of the acquisition value and the tax assessment value of the property and that there is normally no capital gains taxation when disposing a property holding company.

Legal form/tax status

An AB is a limited liability company with a minimum share capital of 25,000 SEK as from 1 January 2020. The AB is taxable on its corporate income at 21.4% (20.6% in 2021). Unless tax losses are expected, corporate income tax is paid by monthly instalments evenly distributed over the year. The tax assessment is done in the year following the financial year, and the corporate income tax return is filed annually.

HB and KB are two types of partnerships that can be incorporated in Sweden. They both follow the same tax and legal regimes, the only difference being that a KB is a limited partnership where one of the partners has a full liability, and a HB is a partnership with joint and several liabilities between the partners. Both types of partnerships are hereinafter referred to as “HB”.

A HB is a legal entity, however not an entity liable to corporate income tax. Instead, the income of the HB is taxed in the hands of the partners. There is no minimum share capital requirement for a HB.

In recent years, a number of measures have been taken in Swedish tax legislation to obtain an equality in taxation between an AB and a HB. Due to this, there is no longer any immediate difference between the two which would motivate one structure over the other. Participation exemption regulations also fully apply to Swedish HBs. Moreover, the corporate income with the HB is assessed in a similar way as is done in an AB. The only major difference being that the profits of the HB are taxed in the hands of the partners.

The taxable income is assessed in the hands of the HB, which means that the HB is liable to file an income tax return. As previously mentioned, the taxable income is taxed in the hands of the partners and distributed to them in accordance with their partnership share in the HB. However, items such as property tax, real estate transfer tax and social security fees – to the extent the HB has employees – shall be paid by the HB.

Foreign partners of a Swedish HB directly holding real estate will always be liable to Swedish tax for the income arising in the partnership.

Distribution of dividends

Dividends received by a resident limited liability company from another resident company are normally exempt from taxation. Received dividends on unlisted shares held as fixed assets are tax-exempt. However, in case the shares are held as current assets, dividends are taxable. Dividends received on listed shares are exempt from taxation, provided that the total shareholding constitutes at least 10% of the voting power in the distributing company, and the company has held, or intends to hold, the qualifying shareholding for at least 12 months.

For dividends received in respect of shareholdings in foreign companies, an additional requirement must be met. The distributing company must be subject to a local tax regime and subject to tax in a similar manner as a Swedish company. Further, the legal characteristics of the company, eg, limited liability for the shareholders, must be similar to those of a Swedish company. If the distributing company is resident in a country with which Sweden has concluded a tax treaty, then the condition of similar taxation in most cases will be regarded as fulfilled. In addition,

a tax exemption on dividend distributions may be available under a tax treaty, if an exemption is not available under domestic law.

The implementation of the general anti-abuse rule (GAAR) included in the EU Parent-Subsidiary Directive (the "Directive") could be regarded as one measure to deal with some hybrid arrangements in connection with BEPS, and to some extent to deal with substance requirements relating to treaty shopping. The changes entered into force on 1 January 2016 are as follows:

- The rules regarding the participation exemption are revised resulting in dividends from shares held for business purposes no longer being exempt if the dividend payments are deducted as interest or other in the country where the shares are domiciled. The rule will apply irrespective of which country the dividend payer is domiciled.
- WHT: clarification of the rule regarding the prevention of situations where formally shares being hold at the time of dividend distribution (instead of the "real" beneficial owner). The wording of the rule will be the same as before, but increased focus on the issue is expected.
- It will be possible to apply for an advance ruling with regard to WHT (within four months from the date of the dividend distribution).

When implementing Article 1.2 of the Directive into Swedish law, the Swedish Government stated that the current anti-avoidance provision in the Swedish Coupon Tax Act (the "WHT Act") is sufficient for the implementation in question. However, the anti-avoidance provision should be interpreted in light of Article 1.2 of the Directive.

When interpreting the anti-avoidance provision in light of Article 1.2 of the Directive, it cannot be ruled out that further substance requirements may apply for holding structures. From a domestic Swedish point of view, it is important to know that no proposals have been presented in which the law is suggested to be amended or applied in this respect, and no guidelines have been issued by the Swedish Tax Agency to that effect.

Capital gains on the sale of shares in a property holding company

In Sweden, the sale of shares in a company whose assets mainly comprise Swedish real estate is not treated as the sale of the real property owned by the company. Companies are normally not taxed on any capital gains realised on the sale of shares. To qualify for an exemption for capital gains taxation, the shares either have to be unlisted or, if they are listed, the owner has to have access to at least 10% of the voting power. If the shares are listed, the disposing company must have held the shares for at least 12 months. Further, non-resident companies could only be subject to tax on capital gains realised on the sale of shares in a real property company, if the shareholder is carrying on an active trade or business in Sweden through a PE and provided that the shares are held as part of the business conducted in Sweden.

Also, capital gains on the disposal of shares in a Swedish partnership are not subject to taxation for a limited liability company but embraced by the Swedish participation exemption regime. Consequently, any loss on disposal of such shares is not tax-deductible. This new regulation also implies that a partnership's capital gains on disposal of shares in a limited liability company or dividends received by a Swedish partnership are not subject to taxation with the partnership or the partnership shareholder.

The exemption for capital gains taxation mentioned above applies only if the shares are regarded as capital assets in the hands of the shareholder. If the shareholder is considered to pursue a business in trading shares or real estate, the shares may be considered as stock assets and hence taxable if disposed. Consequently, it is important to assess the tax treatment before any disposal.

Value-added tax (VAT)

From a Swedish VAT perspective, a sale of a company holding a property is exempt from VAT. Thus, no VAT will be levied on the purchase of the shares in the company. Any existing VAT liability as well as the rights and liabilities to adjust investment VAT in case of any change of use of the property will follow the company.

A purchase of a company holding a property implies that the purchaser inherits all responsibilities regarding the VAT treatment for the previous six years.

Status of double tax treaties (DTTs)

There are DTTs in place between Sweden and more than 90 countries. A Swedish AB is the most common legal entity, and as such, all DTTs are applicable to an AB. Considering that a HB/KB is a partnership and that it is taxed in the hands of its partners, the application of DTTs is subject to a case-by-case analysis.

Direct investment in Swedish real estate

Real estate transfer tax (RETT)

A direct acquisition of the legal title to Swedish property is for legal entities subject to 4.25% RETT. The taxable base for RETT shall be constituted by either the purchase price or the tax assessment value of the real property (whichever is higher) at the time of the acquisition.

The sale of shares in a real property company/partnership is not subject to RETT.

Tax status

Non-resident companies owning Swedish property are taxed on the net rental income in Sweden at the corporate income tax rate of 21.4%(20.6% in 2021). Non-resident companies owning Swedish property are allowed to deduct from their taxable income interest expenses on funds borrowed from, eg, banks or affiliated companies (see below for limitations), and property related expenses.

Withholding tax (WHT)

There is no WHT or branch profits tax applicable to real estate holdings or PEs operating in Sweden.

Capital gains on the disposal of Swedish real estate

Both resident and non-resident companies that own Swedish property are subject to Swedish corporate income tax at the ordinary rate of 21.4% (20.6% in 2021), on any capital gains realised on the sale of real property. All of the income of a corporation is taxed as business income. However, capital losses on real property can only be offset against capital gains on such assets, realised by the company or any other group company. Losses on real property that cannot be used to offset profits in the same financial year may be carried forward and deducted against future gains on real property.

Value-added tax (VAT)

Sale of a property is generally exempt from VAT in Sweden. Thus, no VAT will be levied on the purchase of a property. However, as mentioned above a property-owner may apply the rules regarding voluntary VAT liability relating to permanent letting, ie, one year, of business premises to a business liable for VAT. It should be noted that VATable activities must be carried out in the actual premises.

The voluntary VAT liability arises if VAT is charged on the invoice, furthermore, the invoice must be issued within six months of the beginning of the period of letting. The voluntary VAT liability arises on the first day of the letting period to which the invoice relates, however, at the earliest, on the day when the tenant accesses the premises. Furthermore, for VAT purposes, the purchaser has to be registered in Sweden.

If the landlord accidentally has invoiced VAT on the rent, then the landlord can issue a credit note regarding the VAT amount within four months from the date of the invoice and thereby avoid voluntary VAT liability.

As a main rule the VAT status of the property remains if the property is sold, ie, if the property is subject to voluntary VAT the VAT status will remain with the new owner. There is, however, a possibility for a new owner to exit from voluntary VAT liability if this is agreed by seller and buyer in connection with the transaction.

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Real Estate Going Global

Switzerland

Tax and legal aspects of real estate investments around the globe

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Real Estate Tax Summary

General

A foreign investor is allowed to invest in Swiss real estate property directly or through a local or a non-resident company if such property is used for permanent business purposes. Restrictions apply for Swiss residential properties.

Real estate funds in Switzerland are often structured in the form of an FCP (contractual fund) as well as in the form of a SICAV (investment companies with variable capital). Both forms need to be approved by the Swiss Financial Market Supervisory Authority FINMA. Both investment fund structures can be listed at SIX (Swiss stock exchange) and can be used for direct or indirect real estate investments. Neither an FCP nor a SICAV is in principle subject to Swiss income tax. However, if the fund invests directly into real estate, the net real estate income (and capital) is taxed at the level of the FCP or SICAV. Distributions of a Swiss fund are in principle subject to 35% Swiss withholding taxes (WHT). However, for Swiss funds with direct investments in Swiss real estate no Swiss WHT applies on distributions of real estate income.

Corporate income taxes

Resident companies are subject to Swiss corporate income tax (CIT) on their taxable profits generated in Switzerland. CIT is levied at federal, cantonal and communal level. Foreign sourced income attributable to foreign permanent establishment (PEs) or real estate property located abroad is excluded from the Swiss tax base and only taken into account for rate progression purposes in the cantons that apply progressive tax rates.

Non-resident companies are subject to Swiss CIT if they own real estate property in Switzerland, have loan receivables secured by a mortgage on Swiss real estate property, or deal with or act as a broker of Swiss real estate property. Non-resident companies are taxed on their income generated in Switzerland only.

Switzerland levies a direct federal CIT at a flat rate of 8.5% on profit after tax. Accordingly, CIT is deductible for tax purposes and reduces the applicable tax base (ie, taxable income). Consequently, direct federal CIT rate on the profit before tax amounts to approximately 7.83%. At federal level no corporate capital tax is levied.

In addition to the direct federal CIT, each canton has its own tax law and levies cantonal and communal income and capital taxes at different rates. Therefore, the tax burden of income (and capital) varies from canton to canton. Some cantonal and communal taxes are imposed at progressive rates.

As a general rule, the overall approximate range of the maximum CIT rate on profit before tax for federal, cantonal and communal taxes is between 11.5% and 21.6%, depending on the location of the Swiss real estate.

Thin capitalisation

Swiss thin capitalisation rules are, in general, only applicable for related parties. In case of a thin capitalisation, related party debts can be treated as taxable equity. A circular letter issued by the Swiss Federal Tax Administration provides for debt/equity ratios as “safe harbour” rules. The maximum amount of debt for companies that operate real estate is in general 70%-80% of the market value for its real estate assets (depending on the asset).

Interest deduction

Interest paid on loans from related parties that exceed the above mentioned relevant ratio are not deductible; further these interests may be deemed as a hidden distribution and hence are subject to 35% Swiss withholding tax (WHT).

There are no limitations on the financing by independent third parties (eg, banks) and thus, interest paid to a third party is a deductible business expense. If third party loans are secured by related parties a detailed analysis is required.

In addition to the above, interest rates paid to affiliated companies or shareholders have to reflect fair market rates. With respect to related parties, the Swiss Federal Tax Administration annually issues “safe harbour” interest rates to be used on loans denominated in Swiss francs or foreign currencies.

The corporation may deviate from these “safe harbour” rates as long as it can prove that the rates used are at “arm’s length” and more appropriate in the present case. The cantons usually follow these federal guidelines.

Depreciation

Maximum depreciation rates allowed for tax purposes are issued by the Swiss Federal Tax Administration. There are different rates for commercial buildings, office and bank buildings as well as department stores. Higher depreciation is allowed for tax purposes if the taxpayer can prove that such depreciation is required from a statutory accounting perspective. Some cantons follow the federal guidelines, whereas some cantons apply their own (more liberal) applicable depreciation rates.

Property taxes/capital gain taxation

With regard to the ownership and the transfer of real estate property in Switzerland property taxes may apply. Dependent on the location of the real estate property, ownership related property taxes are levied at the cantonal and/or communal level or do not exist at all.

In the case of the sale of real estate property, real estate transfer tax and taxes on the capital gain may apply.

At federal level, the capital gain realised on real estate held as business assets is subject to ordinary income tax. At cantonal and communal level, the capital gain realised is either subject to the ordinary income tax (dualistic method) or subject to the real estate capital gain tax (monistic method).

Real Estate Investments

Legal aspects

Real estate ownership in Switzerland

In Switzerland, property is guaranteed by the Federal Constitution. Property law, and the various types of property including real estate property, are regulated by the Swiss Civil Code (CC), which differentiates between ownership right and restricted property rights. While the owner of real estate is free to dispose of it within the limits provided by the law, restricted ownership rights can be attached to the real estate property and limit the ownership and the legal control over real estate.

Ownership rights as well as restricted property rights are recorded by the Swiss federal land register. Although the register is called a federal land register, it is managed by the cantons. Anyone is entitled to inspect the land register. The accuracy of the entries in the land register is presumed by law. The argument of being unaware of an entry in the land register has no legal validity.

Ownership

Pieces of real estate are immovable objects (contrary to moveable objects). Ownership can be held either by a single person as sole ownership, or by several persons together as co-ownership or joint ownership.

Sole ownership

The most comprehensive power of disposal and legal control over real estate is granted by the sole ownership, which provides the owner with all powers regarding the object with the exception of regulations by law or by contractual agreement. Furthermore, a sole owner does not have to consider the rights of a co- or joint owner.

Co-ownership

Real estate can be divided into co-ownership shares (*Miteigentum*). Co-ownership is the normal case of collective ownership and implies a division of the property in portions, the so called quotas. Every quota-holder is entitled to use the whole property and each quota may be independently sold or mortgaged. In the case of the sale of a co-owned real estate share, all other quota-holders have the right of first refusal – unless it is excluded by a contract – in order to increase the percentage of their property. The ordinary maintenance (eg, the prevention of damages) can be initiated by every single quota-holder; everything that goes beyond the ordinary maintenance needs the consent of the majority of the quota-holders representing a majority share in the object. The quotas act as a basis for the calculation of the costs for maintenance for each owner. In the event of the sale of the entire parcel, all co-owners must agree unanimously.

The condominium ownership (*Stockwerkeigentum*) is a particular form of collective ownership, whereby the building is divided into special parts for the exclusive usage of the specific condominium owner. The building itself is registered in the land register, and every condominium with its quota and owner is recorded separately on a different page of the register as well. Each condominium has its own access and separate arrangements such as garages, cellars, etc. In the condominium owners' meeting, the owners meet to discuss expenditures and maintenance issues. The voting powers of the owners depend on the quota they possess. Every part can be sold individually, but it is common to agree on a pre-emption right in favour of all other condominium owners.

Joint ownership

Real estate can finally be held in joint ownership (*Gesamteigentum*), where several persons are bound together into a community either by legal provisions (eg, community of property between spouses, family members, heirs) or by contract (eg, ordinary, general or limited partnership). The rights of each joint owner are attached to the whole object and no independent percentage or quota is defined or recorded in the land register. The disposal of a jointly owned object requires the consent of all owners.

Restrictions of ownership

Ownership rights can be restricted by law or by contract. In the case of direct restrictions, the law obliges the owner to tolerate, refrain or act in a certain way. No special private or official order is required, and the restriction does not need to be filed with the land register. Such direct restrictions include, for example, construction law provisions (eg, minimal distance from the property line to a building or maximal height of a building) and neighbour law provisions. Indirect restrictions originate from public and private law. They entitle the beneficiary to a claim towards the landowner that can be enforced if certain conditions are fulfilled. That includes restricted property rights (see section "*Restricted property rights*") and restrictions of disposal (see section "*Restrictions of disposal*").

Restricted property rights (*beschränkte dingliche Rechte*)

Restricted property rights are grouped into easements on property (*Dienstbarkeiten*), real burden (*Grundlasten*) and real estate security interests/liens and mortgages on immovable property (*Pfandrechte*). They can be established by law or by contractual agreement and cause the owner to tolerate, refrain or act in a certain way. A registration in the land register is necessary. If such restricted property rights conflict, the seniority-rule applies, and the more recent established right remains invalid.

Easements on property

Real estate may be encumbered in favour of another property or in favour of a person. The owner of such an object must permit the beneficiary to exercise certain rights over it or he may not exercise certain rights attached to his ownership for the benefit of the beneficiary.

The most common easements on property are the following:

- The right to build (*Baurecht*): The beneficiary has the right to erect or retain possession of a building although he does not own the land. The land remains with the grantor whereas the ownership of the building is with the beneficiary. In other words, the ownership of the parcel itself is separated from the ownership of the building on this parcel. The legal transaction creating such right to build is only valid if done as a public deed. The right to build can be established for a maximum of 100 years and has to be filed with the land register. When the right to build expires, any existing construction reverts to the landowner and becomes an integral part of the parcel.
- Usufruct (*Nutzniessung*): The right of usufruct on property grants the full right of possession and usage of real estate. It can be limited to certain parts of a parcel or a building. The usufruct ends at the expiry of the term, resignation or death of the usufructuary or at the latest after 100 years. Since the plain right of ownership remains with the grantor, the usufructuary must preserve the object in its original condition, carry out repairs and renovations of ordinary maintenance and may not dispose of the object itself. The right of usufruct has to be filed with the land register.
- Right of Residence (*Wohnrecht*): The Right of Residence is a special case of usufruct which grants the usufructuary permission to live in all or parts of a building. The right of residence is personal and therefore neither transferable nor heritable.

Real burden

A real estate charge (*Grundlast*) obligates the owner of an object to take action for the benefit of the entitled beneficiary. The charge needs to be registered in the land register and is only valid for a maximum of 30 years. The liability to perform is restricted to the real estate and not to the owner of the property.

Real estate security interests/liens and mortgages on immovable property

Liens and mortgages intend to secure claims and to mobilise the value of the property. Real estate security interests can be established in the form of a simple mortgage (*Grundpfandverschreibung*) or a mortgage note (*Schuldbrief*). All liens result from the conclusion of a notarised agreement and an entry in the land register. In the cases of the simple mortgage and the mortgage note, the debtor is personally liable. The claim secured by a lien must be exactly defined in its amount and recorded in the land register whereas a simple mortgage allows a claim to be secured even if its amount is not exactly defined. In such a case, a maximum amount is registered in the land register.

Restrictions of disposal

- Right of First Refusal (*Vorkaufsrecht*): On the sale of immovable property to a third party or a transaction with similar effect, the right of first refusal entitles the beneficiary to acquire this object. Unless the duly notarised pre-emption agreement provides otherwise, the beneficiary may purchase the property pursuant to the conditions agreed upon between the seller and the third party. The right has to be exercised within 3 months after having been informed about the transaction. The maximum term of a right of first refusal is 25 years and can be registered in the land register.
- Right of Purchase (*Kaufsrecht*): A right of purchase (call option) entitles the beneficiary to acquire an object at any time by unilateral declaration of intent. The parties have to clearly define the object of purchase and the price in a notarised agreement. The period of such an agreement is limited to 10 years and can be registered in the land register.
- Right of Repurchase (*Rückkaufsrecht*): The right of repurchase can only be concluded with the former owner, typically in a purchase agreement. According to this right, the former owner is entitled to acquire the object under certain circumstances. Such agreement has to be notarised, is only valid for a maximum term of 25 years and can be entered in the land register.

Restrictions on the acquisition of real estate by foreigners ("Lex Koller")

The Federal law on the acquisition of real estate by foreigners, the so-called "Lex Koller", is aimed at restricting the acquisition of real estate by foreigners in Switzerland. Any violation of the Lex Koller has civil and penal law consequences. In essence, the Lex Koller provides that real estate transactions in Switzerland are subject to prior authorisation (which will only be granted if legally defined requirements are fulfilled) if all of the following conditions are met:

- the person acquiring real estate is a foreigner within the meaning of the Lex Koller (see section "*Definition of foreigners*");
- the object of the transaction is a real estate property for which an authorisation is required pursuant to Lex Koller (see section "*No authorisation for commercial properties*");
- the transaction qualifies as acquisition of real estate under the Lex Koller (also including transactions similar to acquisitions, such as establishment and exercise of rights of purchase, rights of first refusal or repurchase rights); and
- the real estate transaction is not exempted from the authorisation requirement (eg, commercial properties, main residence properties).

Definition of foreigners

The following individuals are deemed foreigners within the meaning of the Lex Koller:

- foreigners domiciled abroad; and
- foreigners domiciled in Switzerland, except such persons holding a valid C settlement permit, or citizens of a Member State of the European Union (EU) or the European Free Trade Association (EFTA) and holding a valid EU/EFTA settlement or residence permit (B, C or L permit).

Legal entities and partnerships qualify foreigners, if:

- they have their registered offices abroad (even if they are controlled by non-foreigners or Swiss citizens); or
- they are domiciled in Switzerland but controlled by foreigners. Control is deemed to exist if more than one third of the share capital or the voting rights is owned by foreigners or if material loans are granted by foreigners.

No authorisation for commercial properties

With respect to the object of the transaction, it is important to note that commercial properties are exempted from the Lex Koller. Hence, a foreign investor is allowed to acquire real estate in Switzerland if such property is used for permanent business purposes. Examples for such commercial properties include manufacturing premises, warehouse facilities, offices, shopping centres, retail premises, hotels, restaurants, workshops or medical practices. Therefore, it is irrelevant whether real estate is used by the acquirer or rented out to a third party in order to pursue a business activity. Commercial properties may also be purchased for investment purposes only.

Main residence properties

Foreigners domiciled in Switzerland not holding a C settlement permit (but a valid B residence permit) are entitled to purchase a dwelling (ie, a single-family house or apartment main residence) at their place of residence without prior approval. The main residence must be acquired directly. Further, the purchase of reasonable land reserves (approximately one-third and in special cases up to one half of the total surface area) for expansion in the medium term of an existing or planned business establishment does not require prior authorisation under Lex Koller.

Acquisition of real estate requiring prior authorisation

In principle, prior authorisation is required for the acquisition of undeveloped land in residential, industrial and commercial zones, though this does not apply if construction works (for main residence or permanent business establishment) commence within approximately one year. However, the construction and lease of residential housing is not regarded as a business activity with the result that the acquisition of such real estate would be subject to the Lex Koller.

A foreigner may acquire a holiday home or a serviced flat in an apartment hotel under certain circumstances and only directly with his own name. The dwelling must be in a place designated by the cantonal authorities as a holiday resort. Every authorisation must be deducted from the annual quota assigned to the cantons for holiday homes and serviced flats.

Further remarks regarding Lex Koller

In terms of fiduciary transactions, it should be noted that persons who are, in principle, not subject to Lex Koller (eg, Swiss citizens) are nevertheless considered foreigners for Lex Koller purposes if they acquire a property that falls under Lex Koller on behalf of a foreigner in a fiduciary transaction. Fiduciary transactions are generally viewed as a circumvention of Lex Koller.

Finally, we would like to draw your attention to the fact that the right to acquire real estate in Switzerland under Lex Koller does not confer in any way a residence entitlement to the relevant owner. Residence permits are granted solely on the basis of the applicable immigration laws.

Legislative developments regarding Lex Koller

In April 2015, the Federal Council announced that it would work on a revision of Lex Koller, especially focusing on the question of whether the acquisition of commercial property and the conversion of such property into private living spaces by foreigners shall in future also be subject to prior authorisation.

In July 2018, the Federal Council finally announced that it would forego a revision of the Lex Koller. In the preceding consultation process, the majority of the interested groups had rejected the revision and seen no need for action.

Legislation of secondary homes

On 11 March 2012, the Swiss population voted to accept an initiative which prohibits Swiss communes from having a contingent of more than 20% of secondary homes on their area, compared to buildings used as primary homes. This limitation acts as a complete ban for additional authorisations. Every object whose occupant does not have a domicile in the municipality, falls under the regulation of secondary homes. Owners of secondary homes will still be able to sell their properties as secondary homes in the future but there is no possibility to build new secondary homes if the contingent is exceeded.

On 1 January 2016, the Federal Act on Secondary Homes and the Federal Ordinance on Secondary Homes entered into force, according to which the municipalities are required to annually prepare an inventory of homes. This inventory serves as a basis to determine the number of existing secondary homes. In case the share of secondary homes exceeds the threshold of 20% per municipality, the granting of permits to build new secondary homes is prohibited. However, some exceptions are applicable, for example for tourist accommodations or in case the maintenance of a building within the building zone cannot otherwise be guaranteed. Today, especially in touristic areas, the acquisition of new holiday homes is de facto only possible in form of touristic homes, homes relating to structured form of tourist accommodation (hotels) and protected buildings or landmark buildings.

General tax aspects

Rental income

Net rental income is taxable in Switzerland at the income tax rate applicable in the canton where the property is situated. Tax rates are determined by taking into account income on a worldwide basis. Taxes are levied at both federal and cantonal/communal level. This multi-layered tax system means there are no average tax rates, and so taxes can only be calculated on a case-by-case basis. In some cantons, in the case of pure investments in real estate without any real commercial activity, a minimum income tax may be levied.

The net income from property is measured by the excess of receipts over connected maintenance expenses. In addition, the rental value of an owned apartment or house, either occupied or available for occupation, is regarded as income in-kind, and taxed accordingly. Allowable costs include maintenance costs, running costs, third-party management charges, property taxes and interest payments. The federation and some cantons have the option of allowing a lump-sum deduction instead of actual expenses, usually as a percentage of the rental income. Only actual expenditures are accepted as a deduction for properties forming part of business assets. Any excess of expenses can be used to offset other sources of taxable income.

Property

In addition, cantons levy a wealth tax on individuals as a means of taxing unearned income. Some cantons use the market value of the property for this purpose. However, many cantons use an official valuation, which is generally less than market value. A similar tax, ie, capital tax, limited to the cantonal and communal level, applies to legal entities. Legal entities are taxed on an annual basis on the equity capital of the company and not on the fiscal value of the property.

About half of the cantons also levy an annual immovable property or land tax based on the value of the property. It is paid by both individuals and legal entities and is in addition to the wealth and capital tax. Debts are not deductible. The tax rate varies between 0.01% and 0.3% and is in general calculated on the market value.

Depreciation

Provided it is spread across the expected lifetime and the real estate qualifies as business asset, depreciation charged in a profit and loss account is generally tax-deductible. Guidelines published by the Swiss Federal Tax Administration, which are usually also used by the cantonal tax authorities, indicate the following rates on a reducing balance basis, ie, on the book value.

For commercial buildings, office and bank buildings as well as department stores	**rate (in %)**
On buildings alone where capitalised separately	4
On buildings and land together	3

For factory buildings, warehouses and workshops	**rate (in %)**
On buildings alone where capitalised separately	8
On buildings and land together	7

For hotel and restaurant premises	**rate (in %)**
On buildings alone where capitalised separately	6
On buildings and land together	4

For residential buildings of real estate companies and staff residences	**rate (in %)**
On buildings alone where capitalised separately	2
On buildings and land together	1.5

The rates are halved if a straight-line method is used, ie, the basis of depreciation is the origin acquisition value. Further, if depreciation is made on buildings and land together, the depreciation is only allowed up to the value of the land.

Capital gains on the sale of property

As a general rule, taxable capital gain corresponds to the difference between the net amount realised with the sale and the investment value, including the acquisition price and subsequent improvement costs.

At federal level, capital gains realised on private assets are exempt from income taxation, unless the individual is deemed to hold the real estate as a business asset (eg, when qualifying as a professional real estate broker or if investing in a construction consortium).

At cantonal and communal level, capital gains realised on private immovable property are subject to a special real estate gains tax. In general, a deduction is available, based on the period of ownership. A long-term ownership can reduce the tax to a relatively low level. Where ownership has only been short-term, there is usually a speculation surcharge. The definition of short-term and long-term ownership varies from canton to canton.

At federal level, capital gains realised on business assets are included in profits and are subject to the general profit tax system, which is income tax for individuals or taxes on profits for legal entities. As a result, federal tax is levied in the general way instead of separate real estate gains taxation.

However, at cantonal level, there are two main alternative ways in which gains on business assets are taxed. First, as applied by most of the cantons, the gains are included in the profits and are subject to profit tax (dualistic method). Secondly, in the remaining cantons, gains are subject to separate real estate gains tax (monistic method) while any recaptured depreciation included in the profit is subject to the general profit tax. For example, this approach is used in the canton of Zurich.

Generally, capital losses on immovable business assets are deductible for income and profit tax purposes.

Should a capital gain arise on an immovable business asset located in a canton that levies a special real estate gains tax, such gain can generally be offset against business losses. However, capital gains deriving from private real estate can usually not be offset.

Subject to various conditions, the real estate gains tax on the disposal of real estate used for own residential purposes is deferred in many cantons if proceeds are reinvested in other real estate used as main residency in Switzerland. According to the federal tax harmonisation statute, which is compulsory for every canton, the gains realised on the disposal of real estate will be exempt if the proceeds are reinvested in a substitute residential building.

Capital gains on the sale of shares of real estate company (economic change of ownership)

If a foreign or a Swiss investor holds an interest in a company qualifying as a real estate company, the sale of all or in general the majority of the ownership rights qualifies as an economic change of ownership and triggers real estate gains tax at the cantonal and communal level. Should a foreign shareholder sell his interest in a real estate company, the Swiss tax authorities may be restricted in levying real estate gains tax under certain double tax treaties since the right of taxation of the gain is allocated to the foreign contracting state. At federal level, an economic change of ownership does not trigger income tax but the buyer inherits a latent tax burden on the difference between the tax base of the real estate (in general this value is equal to the book value) and the sales price of the real estate at the level of the company.

Withholding tax (WHT)

WHT on interests

Interest payments are generally not subject to Swiss WHT. However, under several conditions, in the case of collective external financing, eg, through a bond according to Swiss tax law 35% Swiss WHT is due on interest payments. Furthermore, if the lender (third or related party) is domiciled abroad and the respective loan/mortgage is secured by a Swiss immovable property, the corresponding interest payments are subject to a tax at source (for example 17% for Zurich, ie, 3% direct federal tax and 14% cantonal and communal taxes). Based on the applicable double tax treaty, Swiss WHT and tax at source can be reduced or even eliminated.

WHT on dividends

Dividend payments are subject to a 35% Swiss WHT, which can be reduced or eliminated based on the relevant double taxation treaty. In general, relief is granted by refund. With respect to dividends between qualifying related companies, a mere notification procedure may be available for the part exceeding the residual WHT as defined in the respective double taxation treaty.

Participation relief

Dividends received by Swiss tax resident corporations are taxable as profit. However, if the recipient owns at least 10% of the shares or if the market value of the recipient's participation amounts to at least 1 million Swiss franc (CHF), the federal and cantonal/communal tax liability is reduced by the proportion of the net dividend to net profit. The net dividend is the gross dividend less any associated financing and administration costs.

Dividends received by a Swiss tax resident individual are taxable income. At federal level, if the recipient owns at least 10% of the shares, only 70% of the income realised from the dividends is taxed (for both shares held as business assets as well as private means). Several cantons have also introduced similar rules for cantonal/communal taxes (eg, in the canton of Zurich). At the cantonal/communal level a minimum of 50% of the qualifying dividends will be taxed.

Loss carryforward

However, losses can be carried forward for seven years, provided the taxpayer is a legal entity conducting a business and it was not possible to consider these losses when calculating the profits realised in these years. With respect to individuals, losses can be carried forward for seven assessment periods, provided that the taxpayer holds the real estate in its business assets. There are no provisions for the carryback of losses.

Thin capitalisation rules

The thin capitalisation rules are based on an asset test rather than a debt to equity test. The maximum amount of debt for companies that operate real estate is in general 70%-80% of the market value for its real estate assets (depending on the asset). The maximum debt for operation equipment is 50% of the market value. Any debt in excess of this threshold is re-characterised as "hidden equity" and subject to capital tax at the level of cantonal and communal taxes. Any interest paid on hidden equity may be regarded as hidden profit distribution and subject to 35% Swiss WHT.

Intra-group loans

Interest rates used between related parties should reflect fair market interest rates. Interest expenses resulting from rates not reflecting fair market interest rates will be questioned by the tax authorities and are not tax-deductible. To determine the fair market interest rates, the Swiss Federal Tax Administration annually issues "safe harbour" interest rates for related party debt, which is denominated in Swiss francs. For related party debt denominated in other currencies, "safe harbour" interest rates are also published on a regular basis.

Real estate transfer tax

Most of the cantons levy a real estate transfer tax on the transfer of ownership in a property. A transfer of ownership is also given in the case of a purely economic transfer of immovable property such as the transfer of all or the majority of shares in a Swiss real estate company or the entering and leaving of a partnership owning Swiss real estate. The real estate transfer tax is computed on the purchase price. If the purchase price cannot be determined or appears arbitrary or unusually low, the market value is decisive. The rates vary between approximately 0.5% and 3.3%. Although in special cases the real estate transfer tax can be set at a lower rate or not be levied at all. Generally, this tax is borne by the acquirer. In some cantons it is divided between the seller and the acquirer. Usually, real estate transfer tax is not covered by double tax treaties.

A land register and a land public fee at cantonal level on the transfer of immovable properties situated within the relevant canton or commune are also due.

Value-added tax (VAT)

The sale or rent of immovable property is in principle a VAT exempt supply without credit. In principle, no input VAT can be deducted on direct investment costs or other directly attributable costs.

The seller or the renter of immovable property may fully or partially opt for the taxation of the sale or rent under the condition that the immovable property is not used by the recipient exclusively for private residence purposes. In this case, input VAT can be fully or partially recovered on direct investment costs or other directly attributable costs. Since 1 January 2018, the seller or lessor can opt on the transaction with declaration of the VAT on the invoice or with a declaration on the tax return.

The standard VAT rate in Switzerland is 7.7% from 1 January 2018 and 8% until 31 December 2017, related to the opted real estate transactions.

The value of the land is not subject to Swiss VAT. There are no negative VAT consequences for sale or rent of land (ie, no input VAT restrictions applicable).

In connection with the construction of buildings, the following practice has to be considered as per 1 July 2013:

- In case purchase contracts, pre-purchase contracts and/or contracts for work and labour are closed prior to the start of the construction, the supply of real estate is a taxable supply. (In case the civil law requires a notarisation, the contracts are only deemed to be closed in case the notarisation is done.)
- In case purchase contracts, pre-purchase contracts and/or contracts for work and labour are closed after the start of the construction, the supply of real estate is exempt from VAT without credit. The full or partial option to tax for the real estate supply is possible in case the real estate is not used by the recipient exclusively for private residence purposes.

In case the construction of the building started between 1 January 2010 and 30 June 2013, there is a choice to either apply the old practice or the practice as of 1 July 2013.

The following three issues have to be considered in Switzerland when applying the old practice for the time period 1 January 2010 to 30 June 2013:

- The building site is owned by the constructor. In case of several requirements being met, the supply of the real estate is exempt from VAT without credit (option to tax possible on the building in case not used by the recipient exclusively for private purposes). If the requirements are not met, the construction of the building would become a taxable supply of goods.
- The building site is owned by the “buyer”. The supply qualifies as a “construction contract” and therefore qualifies as a taxable supply of goods.
- The building site is owned by a third party, which is not associated with the constructor. In this case, the construction of the building is treated as a taxable supply of goods.

In order to take advantage of the opportunity related to the practice at hand we recommend the following:

- Review how the sale of the real estate has been treated (before completion of the building) from a VAT perspective as per 2010. There is an optimisation potential in case, VAT has been paid in the past.
- Review of contractual clauses from a VAT perspective in connection with the start of the construction work and formal requirements.
- Consider the greater flexibility – especially between group companies – in case the sale of land is conducted between related parties.

Swiss real estate investment funds

General

The regulatory authority for collective investment schemes as well as the fund management companies, and the managers of collective investment schemes is the Swiss Financial Markets Authority (FINMA).

The Swiss Collective Investment Schemes Act (CISA) offers different fund vehicles which allow the investment in real estate assets. Swiss and foreign real estate can be held directly or indirectly by the following FINMA-regulated investment vehicles: the SICAV (investment companies with variable capital), the contractual collective investment fund (FCP, or “*vertraglicher Anlagefonds*”), the SICAF (investment companies with fixed capital), and the LPCI (limited partnership for collective investments). In August 2020, the Swiss Federal Council published the Limited Qualified Investment Fund (L-QIF) dispatch which will – if passed – allow to form unregulated (real estate) investment funds for qualified investors in the future (similar to the Luxemburg RAIF). The L-QIF will probably not be available before the beginning of 2022.

Currently, there are no Swiss SICAFs holding real estate, but there are different unregulated real estate investment companies which fall under an exemption of the CISA because they are either restricted to qualified investors or its shares are listed on a Swiss exchange. The LPCI is a closed ended investment vehicle and therefore suited for the

financing of real estate development projects but not for the mere holding of real estate assets. Swiss LPCIs investing in real estate are rather rarely authorised by FINMA. Furthermore, Switzerland does not have a REIT regime. Hence, the subsequent comments are mainly based on the legal forms of SICAV and FCP which are by far the most used Swiss vehicles for real estate investments.

Tax aspects

Collective investment schemes are generally considered transparent for Swiss tax purposes. The only exemptions are the SICAF (which is regarded as a taxable entity) and collective investment schemes (such as SICAV and FCP) holding direct Swiss real estate investments.

Generally, FCPs and SICAVs are considered as transparent for Swiss tax purposes. An exception to this rule occurs where a generally transparent Swiss (and foreign) collective investment scheme directly holds Swiss real estate. In such a case income derived from Swiss real estate is subject to a preferential statutory income rate for direct federal taxes of 4.25% and in the most cantons of Switzerland to a preferential statutory income rate for cantonal and communal taxes (eg, City of Zurich 9.16%). Both taxes are levied at the level of the collective investment scheme. We note that certain criteria need to be met in order to benefit from the special tax regime as a collective investment scheme. The fund should own at least 10 real estates. Further, the general requirements for the recognition as collective investment schemes apply, ie, there should be several investors.

In case of indirect Swiss real estate investment held by a special purpose vehicle (SPV), the net real estate income is subject to ordinary statutory income taxation (8.5% direct federal taxes and cantonal and communal taxes, eg, City of Zurich 18.32%) at the level of the SPV. Furthermore, the SPV is subject to annual capital taxes on cantonal level.

Depending on the canton where the real estate is located, capital gains realised by the sale of a real estate held by the fund directly or indirectly might be taxed differently at federal and cantonal and communal level, ie, in certain cantons capital gains realised on immovable property are subject to a special real estate gains tax regime (monistic method) instead of ordinary income tax (dualistic method). In general, a deduction is available, based on the period of ownership. A long-term ownership can reduce the tax to quite a low level. Where ownership has only been short-term, there is usually a speculation surcharge. The definition of short-term and long-term ownership varies from canton to canton. At federal level, capital gains realised upon the sale of a real estate are subject to income tax.

For Swiss real estate funds with direct real estate investments no Swiss WHT applies on distributions of real estate income. In case of income from indirect real estate investments and/or other income, distributions (dividend income and/or interest) are subject to a 35% Swiss WHT. Distributions of capital gains are not subject to withholding tax as long as the capital gains are distributed by a separate coupon or are separately disclosed.

The issuance and redemption of shares of Swiss collective investment funds with direct or indirect real estate investments is exempt from Swiss stamp duty.

In the case of a purchase, sale or transfer of Swiss fund units with direct or indirect real estate investments (secondary market transactions) through a Swiss securities dealer (eg, Swiss bank), Swiss securities transfer tax of 0.15% on the remuneration will be levied, which in general has to be borne equally by the seller and purchaser. Certain exemptions might be possible (eg, exempt investors).

Usually, the Swiss fund vehicle has no access to treaty benefits. The exception is that a collective investment scheme may have access to treaty benefits on behalf of its Swiss investors and for the amount relating to the Swiss investors. Switzerland has entered into several mutual agreements with its treaty partners which allow the fund to reclaim foreign withholding tax for their Swiss investors.

Swiss fund vehicles have no access to EU Directive benefits.

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Real Estate Going Global

Taiwan

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

Foreign entities (including individuals and companies) are permitted to purchase real estate in Taiwan, subject to prior government approval. This approval is country-specific, in that the particular country should provide reciprocal treatment for Taiwanese nationals and Taiwanese companies who wish to invest in real estate in that country.

Generally, foreign investors are allowed to acquire or lease real estate property in Taiwan for places of residence, office buildings, shops and factories, etc. If the real estate is acquired for infrastructure projects, overall economic development, or agricultural and animal husbandry projects, foreign investors are required to obtain approval from the competent central authority for the planned investment. The central authority approval, together with other relevant documents, should be submitted to the municipal or county (city) government for approval.

Real Estate Investments

Holding structures

Foreign investors generally hold Taiwan real estate using either a Taiwan corporation or a Taiwan branch of a foreign corporation.

Income tax

The income tax regime in Taiwan is divided into the consolidated personal income tax regime for individuals, or individual income tax, and the profit-seeking enterprise income tax regime for business enterprises, or corporate income tax (CIT). The term business enterprise refers to any entity that engages in business activities or is profit-seeking in nature.

Individuals, irrespective of whether they are residents of Taiwan, are subject to income tax on Taiwan-sourced income defined in the Income Tax Act (ITA). The residence status determines how an individual will be taxed on Taiwan-sourced income and whether the alternative minimum tax (AMT) will be applied. A resident individual is subject to marginal progressive rates (ranging from 5% to 40%) and entitled to personal exemptions and deductions. Non-residents are generally subject to a flat tax rate on gross income received and are not eligible for personal exemptions or deductions.

A resident company in Taiwan is subject to income tax on its worldwide income. The prevailing corporate income tax rate is 20%. A company is deemed to be a resident corporation for income tax purposes if it is incorporated or established under Taiwan Company Act, regardless of whether it is owned by foreign or local investors, or jointly by both. Similarly, a resident foreign company generally refers to a company incorporated in a foreign jurisdiction that has a permanent establishment (PE), ie, a fixed place of business or a business agent, in Taiwan. Resident foreign companies are subject to income tax on Taiwan-sourced income only, at the same rates as Taiwanese resident companies, and are also subject to AMT. Non-resident foreign companies are generally subject to withholding tax on Taiwan-sourced income, unless where separate tax filings are required.

Alternative minimum tax (AMT)

The AMT applies to both resident enterprises and resident individual taxpayers. Under the Income Basic Tax Act (IBTA), taxpayers are required to calculate and report their alternative minimum taxable income (see below) calculated under the IBTA, together with their same year regular income calculated under the ITA. If the regular tax is greater or equal to the AMT, the regular tax must be paid. Conversely, if the regular tax is less than the AMT, the taxpayers pay the AMT instead.

(Alternative minimum taxable income - AMT exemption) x AMT rate

	AMT rate (in %)	AMT exemption (in Taiwanese dollars (TWD))
Resident enterprises	12	500,000
Resident individuals	20	6,700,000

The AMT is designed to guarantee minimum taxes are paid. As such, income exempted from income tax assessment, such as capital gain from securities transaction etc, as regulated under the ITA or other laws, would need to be added back when calculating AMT. Notably, offshore income of resident individuals will be included in AMT calculations.

Transfer pricing (TP)

Article 43-1 of the ITA addresses the adjustment of income necessary for profit-seeking enterprises in Taiwan with respect to “non-arm’s length” controlled (related party) transactions. When filing income tax returns, profit-seeking enterprises engaged in related party transactions that do not fall within the “safe harbour” rules established by the Ministry of Finance (MOF) should disclose information on their controlled transactions in the tax return and prepare

a transfer pricing report. If the Taiwanese dollar amount of the related party transactions falls below the "safe harbour" rule thresholds, the taxpayer may choose to replace the transfer pricing report with other evidentiary documents that prove the pricing of the transactions is at "arm's length".

In addition to the transfer pricing report, the MOF implemented the three-tiered transfer pricing documentation requirement. Corporations will also need to provide a master file and a country-by-country-reporting file, unless the "safe harbour" rules for three-tiered TP documentation established by the MOF apply.

Rental income

Rental income is assessable and taxed at the CIT rate of 20% for companies. In addition, the rental income shall also be subject to a 5% value-added tax (VAT).

Respective marginal progressive income tax rates ranging from 5% to 40% are assessed on rental income received by resident individuals. The rental income of resident individuals is taxed on a deemed profit basis, if the actual cost of such rental is difficult to establish.

Capital gains on sale of property

The ITA taxes on a consolidated basis actual gain from property transactions for both buildings and land (new real property tax regime, or new RPT regime). The new RPT regime has taken effect on 1 January 2016 and is applicable to all properties acquired on or after 1 January 2016, as well as those bought on or after 2 January 2014 if held for less than two years[1]. The tax base is the market value of the properties reduced by related costs, expenses, and increase in government-assessed land value for land value incremental tax (LVIT) purposes. A rate of 20% will apply on Taiwanese corporate taxpayers and resident individuals are subject to 15%~45% tax rate, depending on the holding period (other preferential rates apply if certain criteria are met); whereas, a tax rate of 35% or 45% will apply on non-resident individuals and profit-seeking enterprises with foreign head offices located outside of Taiwan (ie, using Taiwan branch structure), depending on whether the property is held for more than or less than one year.

LVIT will continue to be levied with the implementation of the new RPT regime. The total amount of land value increment calculated for LVIT purpose is deducted from real estate transaction gain to avoid double taxation.

The following is a summary of the new RPT regime:

Item	Description
Taxation scope	Sales of any of the following after 1 January 2016 will be subject to the new RPT regime, except where various criteria are met (see section below on "*Exclusions*"): • building; • building and land where the building is situated thereon; and • land eligible for being granted a construction permit. Exclusions: If the building or land is sold after 1 January 2016, and meets any of the following criteria, the sale will be subject to the old RPT regime instead: • building or land was acquired prior to 2 January 2014; or • building or land was acquired on or after 2 January 2014, but before 1 January 2016, and has been held for over two years.
Tax base	Proceeds from sale of building and land minus: • costs; • expenses; and • the total amount of land value increment calculated based on the Land Tax Act, ie, tax base of LVIT
Tax rate	For Taiwanese profit-seeking enterprises: 20% For resident individuals, building/land held for:

[1] The old RPT regime still applies to properties purchased prior to 2 January 2014, or those purchased after 2 January 2014 but before 1 January 2016, if held for more than two years. Under the old RPT regime, only gain from sale of buildings is subject to income tax assessment, and land value incremental tax (LVIT) applies to increment in government-assessed value of land, ie, land is exempt from income tax assessment. Capital gain is consolidated into the tax return of the resident enterprise, Taiwan branch of a foreign enterprise, or resident individual selling the real property, and therefore is subject to corporate income tax rate of 20% for enterprises (including resident enterprise or foreign enterprise with a Taiwan branch), or progressive tax rates of 5% to 40% for resident individuals, respectively. For non-resident individuals and foreign enterprises without a Taiwan branch, capital gain is subject to 20% income tax rate.

- less than one year: 45%
- more than one year but less than two years: 35%
- more than two years but less than ten years: 20%
- more than ten years: 15%

For profit-seeking enterprises with foreign head-offices located outside of Taiwan, ie, with Taiwan branch, and non-resident individuals, building/land held for:

- less than one year: 45%
- more than one year: 35%

For any profit-seeking enterprise having its head office outside of Taiwan who directly or indirectly owns more than 50% of an offshore company's shares, where at least 50% of the value of such company is comprised of building and land within Taiwan, its income derived from transaction of such offshore company's shares shall be deemed as real property transaction gain, and income taxes shall be calculated and paid in accordance with guidance provided under new RPT regime.

For comparison, the following table is a summary of the difference in income tax implications between the old and the new RPT regime:

Item	**Old regime**		**New regime**	
Taxation scope	Land:	exempt	Land:	taxable
	Building:	taxable	Building:	taxable
Tax base	Sales price - cost - expenses		Sales price - cost - expenses - tax base of LVIT	
Tax rate				
Resident	Enterprise	20%	Enterprise	20%
	Individual	5%-40%	Individual	15%~45%*
Non-resident	Enterprise	20%	Enterprise	35% or 45%*
	Individual	20%	Individual	35% or 45%*

* depending on holding period

Interest expense

Interest expense is allowed as deduction from rental income for corporate income tax purposes, if interest expense incurred is related to the principal and ancillary operations of the company. The deduction of interest expense on related party loans is subject to Taiwan transfer pricing regulations (see section above on "*Transfer pricing*").

Taiwan introduced the thin capitalisation rule in Article 43-2 of the ITA, where deductible interest expense on intercompany loans is capped at a prescribed intercompany debt-to-equity ratio of 3:1. The rule generally applies to profit-seeking enterprises, except banks, credit cooperatives, financial holding companies, bills finance companies, insurance companies and securities companies.

Certain interest cost must be capitalised. An example of such cost includes interest incurred on loans used to finance the construction of a building. Interest incurred for purchase of land before land title transfer is effected shall also be capitalised.

Further, based on Rules Governing Allocation of Costs, Expenses and Losses Related to Tax Exempt Income, interest expense relating to tax-exempt income may no longer be deductible from taxable income. For example, since gain on sale of land is not subject to corporate income tax under the old RPT regime, interest expense in relation to sale of land is subject to restrictions for tax deduction purposes.

Payment of interest to resident individuals or profit-seeking enterprises on loans used to finance the construction of a building and acquisition of land is subject to withholding tax at a rate of 10%. A 20% withholding tax is applied on interest payment to non-resident individuals and profit-seeking enterprises having no fixed place of business in Taiwan, absent any tax treaty. No withholding tax is imposed on interest paid to local banks.

Depreciation

Depreciation of fixed assets for tax purpose is calculated based on useful lives prescribed in the Table of Service Lifes of Fixed Assets. The methods of depreciation allowed under the current tax regulations are straight-line, sum-of-the-years-digit, fixed-percentage on diminishing book value, production unit or working-hour method.

Loss carryforward

Net operating losses can be carried forward for a maximum period of ten years by virtue of Article 39 of the ITA.

Land tax

Land is subject to annual land tax based on government-assessed value. The first rate is the regular progressive tax rate ranging from 1% to 5.5%, depending on the starting cumulative value (SCV) of the said land. The second rate is a special privileged rate applicable to various types of land ranging from 0.2% to 1%.

House tax

Buildings are subject to house tax imposed on the taxable present value announced by the government. The building tax rate for commercial properties is 3% to 5% of the assessed value, and the rate for non-commercial properties is 1.2% to 3.6% of the assessed value.

Deed tax

Deed tax is imposed on transactions that involve purchases and sales, acceptance of diens, exchanges, bestowal or partition of, or on, immovable property, or acquisition of ownership of immovable property by virtue of possession. Immovable property refers to both land and land fixtures. However, if land is located in an area where LVIT is assessed, no deed tax shall be imposed, so deed tax is collectible, in effect, only on land fixtures such as buildings.

The applicable tax rates range from 2% to 6%, depending on the classification of each deed. Specifically, deed tax on sales and acquisitions is 6% on the government-assessed value of the property, where deed tax shall be filed and paid by the purchaser.

Stamp tax

Stamp tax is imposed on deeds or contracts for sale, gratuitous transfer, partition or exchange of real estate or pledge of lien on real estate to be submitted to government agencies for registration. The current tax rate is 0.1% of the government-assessed present value of real estate.

LVIT

LVIT is levied on the increased published present value of land upon the transfer of legal title of land and is borne by the seller. The tax liability is calculated based on the published present value promulgated annually by the government. The tax rates for LVIT are as follows if the land is held for less than 20 years:

For value increase of less than 100% of the previous published present value, LVIT shall apply at the rate of 20% on the increased value.

For value increase of more than 100% but less than 200% of the previous published present value, LVIT shall apply at the rate of 30% on the increased value falling within this range.

For value increase of more than 200% of the previous published present value, LVIT shall apply at the rate of 40% on the increased value falling within this range.

The present value of land is assessed and published annually, taking into consideration such factors as the development of each geographic district and inflation rate.

VAT on sale of property

VAT is exempt on the sale of land. A 5% VAT will be assessed on the sale of buildings.

Real property securitisation

The Real Property Securitisation Law (RPSL) was officially promulgated with a view to revitalising the real estate market, heighten the liquidity of real estate, and bring greater diversity to the securities market. The RPSL provides two possible methods to securitise real properties, namely “real estate investment trust” (REIT), and “real estate asset trust” (REAT). The RPSL also incorporates real estate development trust.

Income distributed to beneficiary certificate holder of REIT or REAT shall be subject to the following withholding tax treatment:

10% withholding tax for resident companies (interest income to be consolidated in corporate tax return) and 10% final withholding tax for resident individuals.

15% final withholding tax for non-resident companies and non-resident individuals.

Tax implications of repatriation of income

Corporate dividends on after-tax profits paid to foreign investors are subject to withholding tax. The standard dividend withholding tax rate is 21%. This withholding tax may be reduced if the foreign shareholder is a tax resident of a country which has a signed and effective tax treaty with Taiwan. Foreign investors that invest in Taiwanese real estate using Taiwan branch of a foreign corporation are not subject to Taiwan withholding tax on repatriation of after-tax profits to the foreign head office (ie, there is no branch profit tax in Taiwan). With respect to taxes on capital gain from sale of property, please refer to the section “*Capital gains on sale of property*” above.

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Thailand

Tax and legal aspects of real estate investments around the globe

2020

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Real Estate Tax Summary

General

Ownership of land is generally not open to non-Thai nationals. Foreign investors may directly invest in certain property in Thailand such as condominiums or may structure investment in land and/or buildings through a local company. Companies granted investment promotion privileges by the Thailand Board of Investment (BOI) may be permitted to own land.

Rental income

Real estate investment or development companies are subject to Thai corporate income tax at 20% on net taxable profits.

Small or medium-sized enterprises, defined as companies or partnerships with paid-up capital on the last day of the accounting period not exceeding 5 million Thai baht (THB) and with income from the sale of goods and the rendering of services within the accounting period not exceeding 30 million THB, are subject to reduced rates of tax as follows:

Net profits (in THB)	Tax rate (in %)
0 to 300,000	0
300,001 to 3,000,000	15
3,000,001 or more	20

Exemption or reduction in corporate income tax rate is also available for certain real estate activities under privileges granted by the BOI.

Rental income and other income derived from real estate in Thailand are taxable. Expenses incurred wholly and exclusively for the purpose of the business are deductible, except those specifically listed in the corporate income tax law, eg, excessive entertainment expenses and artificial or fictitious expenses.

There is no required debt/equity ratio for tax purposes. Interest on a loan used to finance the acquisition of a real estate property is deductible from the date the acquired asset is ready for use in business.

Interest incurred on the acquisition or construction of real property before the property is ready for use must be capitalised as part of the cost of the asset and may be depreciated once the asset is ready for use in business. The interest is then depreciated over the life of the asset and subject to the depreciation rates prescribed below.

Interest incurred on construction of property for sale is treated as part of the cost of construction until the property is ready for sale.

A market rate of interest must be charged on intercompany lending between Thailand resident companies.

Specific transfer pricing provisions that were introduced in late 2018 are applicable for accounting periods starting on or after 1 January 2019. The transfer pricing rules adopt the “arm’s length” principle.

There is no group taxation in Thailand.

Stamp duty is levied at the rate of 0.1% on the rental value over the period specified in a lease contract.

Depreciation

The maximum rate of depreciation for capital expenditures is 5% for buildings, 20% for machinery and other assets and 10% for lease rights, or over the lease period for leases of definite duration. The depreciation rate will be calculated based on the acquisition cost.

A revaluation of assets will have no effect for tax purposes. Any write-down in the value of assets will not be tax-deductible. Any increase in the value of assets will not be taxable.

Land cannot be depreciated.

Capital gains on the sale of property

The gain derived from the sale of property is taxed as ordinary income.

Recognition of income

Income from a lease is recognised pro-rata over the term of the lease. If the lease is prepaid, the lessor has the option of recognising the income in the period in which payment is received.

Income from sale of property by a property development company may be recognised using one of the following methods:

- at the point ownership is transferred;
- percentage of completion;
- instalment basis (where payment is by instalments).

Withholding tax on dividends

Dividends distributed by a local company to its foreign shareholders are subject to a dividend withholding tax (WHT) at 10%. A double tax agreement (DTA) with Taiwan came into effect on 1 January 2013, which reduces WHT on dividends to 5% in certain circumstances. Currently, this is the only DTA which provides for a rate of WHT below the statutory rate of 10%. However, certain DTAs contain “most favoured nation” clauses which (in theory) reduce WHT for those jurisdictions to 5%, as a result of the DTA with Taiwan. This has yet to be confirmed by the Thai tax authorities.

Loss carryforward

Net losses may be carried forward over five consecutive years. No carryback of losses is allowed.

Extended loss carryforward is available under privileges granted by the BOI. Under privileges granted by the BOI, losses can be carried forward for five years from the end of a tax holiday period. There is no requirement to first offset such losses against profits generated during the tax holiday.

Real estate transfer tax/other taxes

Transfer of real property is subject to a property transfer fee, and stamp duty or specific business tax.

The standard transfer fee is 2% of the government assessed value of the property.

Stamp duty of 0.5% of the transfer value is payable except where the seller is subject to specific business tax (SBT).

SBT of 3.3% is payable on the transfer value on transfer of real property (the actual SBT rate is 3% and the effective rate of 3.3% includes a municipal tax of 10%, which is paid to a local authority). SBT is imposed on the sale of an immovable property requiring registration for change of ownership at the Land Department.

A resident enterprise is subject to SBT on the sale of immovable property in a commercial manner or for profit, irrespective of the manner in which the property was acquired.

In certain circumstances, the transfer of real property is not subject to SBT if the seller is an individual, including:

- The seller has owned the property more than five years before the transfer.
- The seller transfers the real property to a legal heir or an heir under a will.
- The seller transfers the real property to a legitimate child, but not including an adopted child.
- The seller transfers the real property without consideration to a government agency.

In order to permit funding arrangements that are compliant with Sharia law, as of 31 December 2005, the transfer of land or property to a purchaser under a hire-purchase agreement with the Islamic Bank of Thailand is exempt from both stamp duty and SBT.

Other SBT exemptions on the sale of immovable property are available to the National Housing Authority and for Property Funds Type I, II, or IV. In addition, income from the sale of immovable property that falls under an entire business transfer or partial business transfer may also be exempt from SBT provided conditions are met.

The buyer of property, which is a corporate entity, must deduct from payment made to a seller, which is a corporate entity, 1% on account of corporate income tax. The tax can be credited against the income tax of the seller.

Land and building tax

The new Land and Building Tax Act ("Act') B.E. 2562 came into effect on 13 March 2019. The new Act revokes and replaces the House and Land Tax Act B.E. 2475 and its related amendments.

Under the Act, both individuals and juristic persons who have ownership, possessory or usage rights over land or buildings (including condominium units) as of 1 January of each year will be required to pay land and building tax to the local administrative authorities. Payment is due in April of each year.

The official assessed price of the land, building or condominium unit as determined by the government authority for the purpose of collecting registration fees under the current Land Code is used as the basis for calculation of the land and building tax.

The Act sets a ceiling tax rate for the different categories of property. The first two years of tax collection starting 1 January 2020 is regarded as the transition period where reduced rates apply.

Usage	Maximum tax rate (in %)	Transition period tax rate (in %)
Agricultural	0.15	0.01-0.1
Residential	0.3	0.02-0.1
Commercial, industrial or other	1.2	0.03-0.7
Vacant/unused	1.2*	0.3-0.7

*If the land or building remains unused for more than three years, the rate increases by 0.3% every three years until the rate reaches 3%.

The Act provides specific tax reductions if the criteria as set out under the Act are fulfilled and also tax exemptions.

The tax exemptions include the following:

- land or a building that is worth up to 50 million THB used for agricultural purposes;
- land or a building that is worth up to 50 million THB used for residential purposes, provided the owner's name is on the house registration book as of 1 January of that year; and
- a building (not land) that is not worth up to 10 million THB and is used for residential purposes, provided the owner's name is on the house registration book as of 1 January of that year.

Other relevant taxes

Local development tax

Local development tax is based on the value of land (excluding improvements) and ranges from 0.25% to 0.95% annually. Assessments are calculated on the area of the land and on the median value of the land as assessed by the district authority. Land considered "idle" is subject to tax at twice the standard rate. However, local development tax is exempt in cases where the land is subject to the land and building tax.

Land windfall tax

Thailand has proposed a new land windfall tax for owners of properties who have benefited from an increase in the values of their properties due to government infrastructure projects. To date, the legislation has not been issued.

Properties located within a certain distance from a government infrastructure project will be subject to a flat rate of tax not higher than 5% on the inflated value resulting from the infrastructure project.

The tax is applicable when the ownership of properties is transferred during the time period from the start of the government infrastructure project to the completion. The distance is dependent on the type of government infrastructure project, eg, train station, airport, docks, etc.

The following properties will be subject to the land windfall tax:

- properties which are used for commercial purposes that have a value of 50 million THB or more; or
- property development projects having a value of 50 million THB or more.

To date, the government has not provided any updates of the land windfall tax.

Value-added tax (VAT)

The current rate of VAT is 7%.

Leasing or selling of immovable property is exempt from VAT. Consequently, a real estate lessor may not recover input VAT incurred in business, including VAT incurred in the construction of real property.

If the company also engages in business subject to VAT, such as the provision of services or lease of movable property, it may be able to partially recover VAT arising on the construction of real property.

Real estate investment trust (REIT)

A REIT is an investment vehicle listed on the Stock Exchange of Thailand (SET). Investors may purchase and hold trust units in the REIT.

The paid-up capital of a REIT must be not less than 500 million THB. The REIT may invest in leasehold and freehold property. It may also hold not less than 99% of the capital of companies established for the purpose of investing in leasehold or freehold property.

A REIT may borrow up to a limit of 35% of total asset value (60% if the REIT obtains investment grade credit rating).

A REIT is not subject to corporate income tax on its earnings. It is subject to VAT, SBT and stamp duty.

Investor income from trust units is treated in much the same way as income from shares. Distributions of profits are subject to withholding tax of 10%. Capital gains derived by a domestic or non-resident corporate investor are subject to tax unless exempt under a double taxation agreement.

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The Netherlands

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Real Estate Tax Summary

General

A foreign investor may invest in Dutch property in various manners. The investor may invest directly, through a Dutch company (such as a *naamloze nennootschap,* or NV, *besloten vennootschap*, or BV), a non-resident company or through a partnership. Dutch and non-resident companies as well as non-transparent partnerships are subject to Dutch corporate income tax on any income and gains realised from Dutch real estate.

On Budget Day 2019, the Dutch Government presented the Tax Plan 2020, containing a number of important changes and amendments to the Dutch tax legislation for 2020 and onwards. We refer to these new proposals to the extent important. It should be noted that these proposed changes and amendments may still be subject to the changes during the legislative process and subject to the approval of the upper and lower house.

Rental income

Income from Dutch real estate is taxable in the Netherlands at the rate of 25% (2020). Profits up to 200,000 EUR are taxed against a reduced corporate tax rate of 16.5% (2020). On Budget Day 2019, the Dutch Ministry of Finance announced changes in the statutory corporate income tax rates. The corporate income tax rate will be reduced to 21.7% in 2021. The step-up rate for profits up to 200,000 EUR will be reduced to 15% in 2021.

Taxation takes place on the basis of net rental income as determined on the basis of Dutch tax accounting principles. For that purpose, gross rental income is reduced with deductible expense such as management costs, maintenance and interest on loans taken up to finance the property. Certain expenses, such as costs related to the acquisition or improvement of the property must be capitalised and are added to the tax book value of the property. Subject to certain limitations a tax-deductible depreciation can be taken into account over the cost price of the property.

Thin capitalisation rules and other interest deduction limitations

There are no thin capitalisation rules in the Netherlands. However, there are various specific interest capping rules in Dutch tax law. Interest capping rules apply to interest paid to related parties on loans that are taken up to finance certain specific transactions. A loan taken up to finance a direct acquisition of Dutch property does not fall under these rules. From 2019, interest deduction limitation rules regarding excessive participation debts and excessive acquisition debts have been abolished with the introduction of the earnings stripping rule, limiting the deduction of net-interest expenses in excess of 30% of a taxpayer's tax earnings before interest, taxes, depreciation and amortisation (EBITDA) – see section "*Financing the acquisition of Dutch property/Debt financing/Earnings stripping rule (ATAD I)*" below.

Apart from aforementioned interest capping rules provided by law, interest on related party loans is only deductible as far as the terms of the loan are at "arm's length" both from the perspective of creditors risk as well as interest pricing. In case the terms of the loan are not at "arm's length" (part of) the interest may be non-deductible. In certain cases, a loan may be qualified as equity for tax purposes in which case the interest is not deductible at all.

The Netherlands does not levy withholding tax (WHT) on interest. However, a conditional WHT will be introduced as of 2021 – see section "*Withholding tax*" below. Further, there is no tax on the repatriation of Dutch source real estate income of a non-resident taxpayer.

Further restriction may apply under the anti-hybrid rules implemented from 2020. For further details, see section "*Financing the acquisition of Dutch property/Debt financing/Anti-hybrid rules (ATAD II)*" below.

Fiscal unity

Under certain conditions, Dutch companies and EU resident companies subject to corporate income tax in the Netherlands on Dutch source (real estate) income may form a fiscal unity for corporate income tax purposes. Within the fiscal unity, profits and losses are taxed on a consolidated basis.

Tax depreciation

Property should, in principle, be stated at historic cost price including all acquisition costs. This amount forms the tax book value upon acquisition. Tax depreciation can be applied over the tax book value. The cost price of the land cannot be depreciated. The depreciation basis is equal to the cost price of the building reduced with the residual value at the end of the useful life of the building. Commercial real estate can generally be depreciated on a straight-line basis over 30 years.

Tax depreciation of a property is no longer allowed when the tax book value (ie, acquisition costs less accumulated depreciation) falls below the official property's fair market value for tax purposes (WOZ value). The WOZ value is annually determined by the municipal tax authorities. The WOZ value is based on the assumption that the property is on freehold and free of lease. As a result, the WOZ value of commercial properties may be lower than the fair market value of such property.

Under Dutch tax accounting principles, a property may be valued for tax purposes at fair market value in case the fair market value is lower that tax book value. Any resulting impairment is tax-deductible for corporate income tax purposes. If there is a significant and permanent reduction of the value of the property, the property has to be written-down for tax purposes. An impairment to fair market value is not restricted by the WOZ value.

Capital gains on the sale of property

Entities are subject to Dutch corporate income tax on capital gains realised upon the sale or transfer of Dutch property. A capital gain is equal to the difference between the net sales proceeds and tax book value.

It is possible to defer taxation on capital gains realised on the sale of Dutch property by creating a so-called “reinvestment reserve”. The company forming the reinvestment reserve must make a qualifying reinvestment in the year of sale, or within three years after the end of the financial year of the sale. For investment property this implies that a reinvestment has to take place for a value at least equal to the sale proceeds of the asset sold. The reserve must be deducted from the purchase price of the newly acquired property, resulting in a lower tax book value of the replacing asset.

Gains from the sale of shares in a Dutch real estate company by a non-resident corporate investor is – apart from specific abusive situations – not subject to corporate income tax in the Netherlands.

Participation exemption/WHT on dividends

Dividend income of a Dutch holding company derived from a subsidiary is exempt from Dutch corporate tax under the Dutch participation exemption, provided that the holding company holds an interest of at least 5% in the share capital of the subsidiary company and certain other conditions are met. This also applies to a capital gain realised on the sale or transfer of shares in the subsidiary company.

The Dutch participation exemption will be applicable to a participation in a subsidiary that is not held for the purpose of a portfolio investment (“intention” test). A subsidiary that is held as a portfolio investment can, however, be regarded as a “qualifying portfolio investment participation” if either the “asset” test or the “effective tax rate” test is met. A subsidiary of which the assets consist for more than 50% of real estate is a “qualifying portfolio investment participation”.

As a main rule, dividends distributed by a Dutch resident are subject to Dutch dividend WHT at the rate of 15%. There is no WHT on dividends distributed within a fiscal unity for corporate income tax purposes. In addition, no dividend WHT is due on dividends paid to a Dutch shareholder or foreign shareholder established in the EU or in a country that has concluded a double tax treaty (DTT) with the Netherlands, if such a shareholder has a participation qualifying for the participation exemption in the company paying the dividend (amongst others, this requires a participation of at least 5%). Further, the structure should not be deemed as abusive or artificial.

Also, it has been announced that the legislator is considering implementing a conditional WHT on dividends paid to low tax jurisdictions or non-cooperative countries from 2024.

The participation exemption is not applicable on distributions of profit that have been tax-deductible at the level of the subsidiary company.

Loss carryforward

In principle, the carry forward of tax losses is limited to six years. Tax losses can be carried back one year. Losses carried forward can be offset against future net rental income and capital gains.

Real estate transfer tax

The acquisition of legal and/or economic title to Dutch property is in principle subject to 6% real estate transfer tax on the fair market value (a 2% rate applies to residential property). The rate for non-residential properties will increase to 7% from 2021. Various exemptions are available. The most important ones are the exemptions in case of a legal (de)merger or internal (group) reorganisation as well as the exemption for transfers of real estate that are subject to value-added tax (VAT) by law. Various detailed conditions apply.

The acquisition or expansion of an interest of at least one-third of a real estate company is subject to real estate transfer tax as well. A real estate company is a company of which the assets consist for at least 50% out of property and for at least 30% out of property situated in the Netherlands. In this case, the tax is based on the pro rata part of the fair market value of the Dutch property represented by the shares acquired.

Value-added tax

As a main rule, the supply and lease of immovable property is VAT-exempt. There are, however, some exceptions to this general rule, in which VAT is due. The transfer is VAT taxed by virtue of law if the transfer concerns the transfer of (1) a property that is transferred within two years after the property is taken into first use (ie, new(ly) developed property) and (2) building land. In addition, the transfer/lease of a property is VAT taxed if parties jointly opt for a VATable transfer/lease. Such an option can be included in the notarial deed of transfer/lease agreement or a request can be filed with the Dutch tax authorities. An option for VATable transfer/lease can only be considered if the property will be used for at least 90% VAT taxed activities. It could be beneficial for the supplier/lessor to opt for a VATable transfer/lease, since due to the VATable transfer/lease the supplier/lessor is entitled to recover the VAT incurred on disposal fees/investment and exploitation costs.

In case of a VATable supply/lease, the applicable VAT rate is 21% (2020).

Local taxes

Every owner or user of properties located in the Netherlands is liable to local levies, such as property tax (except for users of residential real estate) and land draining rights. These taxes are usually based on the WOZ value of the property as established by the municipal tax authorities on an annual basis.

Real Estate Investments

General

Property investment has witnessed a considerable evolution in the last decades. Most investors and developers have extended their goals from the national to international level. As a result, they increasingly require the services of international property advisers. Among these services, tax will be of significant importance in the property business. In fact, maybe more than in other sectors of the economy, taxation of the transactions performed will impact the investor's net return.

Direct investments in Dutch property

Corporate and individual investors wishing to invest in property located in the Netherlands will have various options as to the structuring of such an acquisition. Basically, the choice will be between a direct holding of property and an indirect holding, ie, through holding shares in a company owning the property. In this chapter the tax issues of direct investments are discussed.

Whatever the status of an owner of property located in the Netherlands (whether a private individual or corporate body, resident or non-resident), the taxable basis of income derived from the property will be determined according to Dutch national tax law.

Similarly, in respect of indirect taxes, the Dutch real estate transfer tax or VAT rules may apply on any transaction performed on property located in the Netherlands.

Corporate tax

Resident companies

Dutch limited liability companies incorporated under the laws of the Netherlands (*besloten vennootschap*, or BV and *naamloze vennootschap*, or NV), are deemed to carry out a business undertaking by law and are subject to Dutch corporate tax on their worldwide income. Taxable income realised by a BV or NV company is subject to a flat corporate tax rate of 25% (2020). On profits up to 200,000 EUR, a reduced corporate tax rate of 16.5% applies (2020). On Budget Day 2019, the Dutch Ministry of Finance announced changes in the statutory corporate income tax rates. The corporate income tax rate will be reduced to 21.7% in 2021. The step-up rate for profits up to 200,000 EUR will be reduced to 15% in 2021.

The basis of the taxable income of a BV or NV company investing in Dutch property is the gross income realised on the property less allocable expenses and depreciation.

Allocable expenses include repair, maintenance, renovation and similar costs and interest expenses on loans taken out to finance the acquisition of the property. For an outline of Dutch regulations on the limitation of interest deduction, see section "*Financing the acquisition of Dutch property*".

With the exception of land, property is depreciable. The depreciation method generally used for corporate tax purposes is the straight-line method. The original acquisition cost (ie, the acquisition cost plus-related expenses such as registration duties, brokerage fees, notary's fees, architect's fees, transfer tax, non-recoverable VAT, etc) is the basis for depreciation and the depreciation rate should be based on the expected useful life of the assets. As a general rule, depreciation rates up to 3% are acceptable for commercial properties like office buildings. However, if it can be substantiated that the useful life of the property is shorter, a higher depreciation rate may be applied. The land and the capitalised expenses related to the land cannot be depreciated.

Tax depreciation of a property is no longer allowed when the tax book value (ie, acquisition costs less accumulated depreciation) falls below the official property's fair market value for tax purposes (WOZ value). The WOZ value is annually determined by the municipal tax authorities. The WOZ value is based on the assumption that the property is on freehold and free of lease. As a result, the WOZ value of commercial property may be lower than the fair market value of such property.

Under Dutch tax accounting principles, a property may be valued for tax purposes at fair market value in case the fair market value is lower that tax book value. Any resulting impairment is tax-deductible for corporate income tax purposes. If there is a significant and permanent reduction of the value of the property, the property has to be written-down for tax purposes. An impairment to fair market value is not restricted by the WOZ value.

Entities subject to Dutch corporate income tax on capital gains realised upon the sale or transfer of Dutch property. A capital gain is equal to the difference between the net sales proceeds and tax book value.

It is possible to defer taxation on capital gains realised on the sale of Dutch property by creating a so-called "reinvestment reserve". The company forming the reinvestment reserve must make a qualifying reinvestment in the year of sale, or within three years after the end of the financial year of the sale. For investment property this implies that a reinvestment has to take place for a value at least equal to the sale proceeds of the asset sold. The reserve must be deducted from the purchase price of the newly acquired property, resulting in a lower tax book value of the replacing asset.

As a result, the gain on the disposal of the property will be rolled over into the new property and will become taxable when the new property is disposed of. At the time the company no longer has the intention to acquire new property, or at the end of the three-year period, the amount of the fiscal reserve is added to the taxable income of the company.

The reinvestment reserve of a company, of which 50% or more of the assets consist of portfolio investments must be added to the profit in the event of a change of 30% or more of the ultimate ownership of the company's capital.

Non-resident companies

The Dutch taxable profit of non-resident companies investing in Dutch real estate is subject to the same Dutch corporate tax regime as that of Dutch resident companies. Non-resident companies are however only taxed over income and costs (including debt funding) connected to the Dutch real estate asset.

Loss compensation rules

Losses relating to the property can be offset against any other taxable income generated by the BV or NV company (or non-resident company) in the same year. The carry back of tax losses is limited to one year. Carry forward of tax losses is limited to six years.

However, losses incurred by a "pure holding" or "group finance" company can only be offset against profits in other years, provided that the company qualifies as a "pure holding" or "group finance" company in such other year and the balance of the loans to and from related parties is not higher than in the year the loss was realised.

Upon a 30% or more change of the of the ultimate ownership of a company, it will no longer be possible to offset tax losses incurred before the change of control with profits realised after the change of control.

A change in the ultimate control in the company is disregarded for purposes of the 30% change-of-control criterion, if the change results from the transfer of shares pursuant to inheritance or matrimonial law, or is the result of an increase in control by an ultimate shareholder who already held a one-third interest in the company at the beginning of the oldest year for which the losses are still available.

Further, if a 30% change of control took place but the company was not or could not have been aware of this change, then the provision does not apply, provided that the change can be considered ordinary trade in the shares of the company at the stock exchange. This can be determined by comparing the trade in these shares with the average trade in these shares in previous years. Furthermore, takeovers, mergers and demergers are not considered usual trade.

Losses are also still available for carry forward in the situation that 30% or more of the ultimate control has changed, and both the "passive investment" and "activity" tests have been met.

"Passive investment" test

The "passive investment" test is met if, during the year the loss was realised and the year the loss was offset against taxable profit, no more than 50% of the assets of the company comprised of portfolio investments for a period of at least nine months in each of these years.

For the purposes of the "passive investment" test, cash as well as real estate, which is made available to third parties, is deemed to be a portfolio investment.

"Activity" test

The "activity" test is met provided that the following is met:

- Immediately prior to the change of ultimate control, the level of activities of the company was not reduced by more than 70% compared to the level of activities at the beginning of the earliest year in which the tax losses are still available for carry forward (scale-down operations).
- At the time of the change in the ultimate control, there was no intention to, within a period of three years, reduce the level of activities performed at that time by more than 70% of the level of activities performed at the

beginning of the earliest loss year for which the losses are still available for carry forward (scale-down operations).

The “activity” test should be applied at the level of the taxpayer. Consequently, if a company is part of a fiscal unity, the “activity” test should apply to the entire fiscal unity, ie, the parent company is the representative taxpayer for all the companies that are part of the fiscal unity.

For the purposes of the “activity” test, the understanding of the earliest year is the following:

If the main activity of the company at the time of the earliest loss year is started or acquired in that earliest loss year or in the three preceding years, then the level of activities immediately before or at the time of the ultimate change of control may not be reduced to less than 30% of the level of these activities in the loss year with the highest level of these activities.

In the case of a scale-down of activities (ie, when not meeting the “activity” test), at the taxpayer’s request, losses resulting from these activities may be offset against profits from business activities that were already being performed immediately prior to the change in ultimate control. This is not possible if the “passive investment” test is not met.

Offsetting tax losses against past profits is, in principle, not allowed if the ultimate control in the taxpayer has changed by 30% or more in the period between the year of the change and the beginning of the third year prior to the change. These losses can be carried back, however, if the following is met:

- In the period between the profit year and the loss year, the business activities of the taxpayer have not ceased almost entirely.
- No more than 50% of the taxpayer’s assets comprise investments for a period of at least nine months in the year in which the losses were incurred, and in the year in which the losses are to be offset.
- Immediately prior to the change in the ultimate control, the business activities had not been reduced by more than 70% compared with those at the beginning of the first year in which tax losses were incurred (scale-down of operations).
- At the time of the change in the shareholding, there was no intention to reduce the business activities by more than 70% as compared with those at the beginning of the first year in which tax losses were incurred (scale-down of operations).

For certain aspects of this regulation, an advance-ruling request can be made to the tax inspector. Taxpayers are entitled to appeal against the tax inspector’s decision.

If, as from a certain date, tax losses can no longer be offset against profits generated after that date as a consequence of this provision, the company may revalue the assets it held prior to the relevant date up to a maximum of their market value. In this way, losses incurred prior to the change of shareholders can be offset against existing deferred capital gains.

Personal income tax

Resident individuals

The income of Dutch individuals is allocated to three “boxes”. Each of these boxes has a separate tax treatment.

The main types of income taxed on the basis of Box 1 are income out of employment and business profits. This income is subject to progressive income tax rates with a maximum scale rate of 49.5% (2020 and 2021).

Box 2 mainly contains income out of shareholdings of at least 5% such as dividends and capital gains. This income is taxed at a flat rate of 26.25% (2020, 26.9% in 2019).

Finally, the income tax regime of Box 3 is applicable to savings and investments of a private individual (including shares, ie, shareholdings less than 5%, and property investments). The total net value of the individual’s savings and investments is taxed on the basis of a capital yield tax. The tax is based on a notional yield calculated on the basis of three ascending fixed percentages and taxed against a flat rate of 30%. These percentages have been determined on the basis of relevant market information and investment results and will be reassessed periodically. The following percentages will apply (as progressive brackets):

- 1.79% (2020) for the total value of net assets from 0 EUR to 72,797 EUR;
- 4.19% (2020) for the total value of net assets from 72,798 EUR to 1,005,572 EUR; and
- 5.28% (2020) for the total value of net assets exceeding 1,005,573 EUR.

If property is held as a portfolio investment, the so-called “capital yield tax” will apply (Box 3). Under certain defined circumstances, passive property investments that are leased to certain related companies or individuals do fall within Box 1 rather than Box 3.

For the purpose of Box 3 the value of the property (with the exception of residential property) will not be determined on the basis of the Property Valuation Act (WOZ), but on the basis of the open market value. The capital will be set at the taxable capital on 1 January of each calendar year.

Of the taxable capital of Box 3, in 2020 an amount of 30,846 EUR will be tax-free.

As a result of the notional yield, no taxable losses can be realised within Box 3. It is, therefore, not possible to set off any negative results actually realised on property held as portfolio investment against positive results from other sources of income, such as income from employment or business profits.

If net operating revenues and capital gains deriving from Dutch property are qualified as business profits or as income from independently performed services, they will be taxed at the Box 1 progressive tax rate (with a top rate of 49.5% in 2020 and 2021). This can be the case if the activities in relation to the property investment go beyond those of a passive investor (property development, trading, etc).

If a substantial interest holder makes property available to the company in which the substantial interest is held, the actual income is taxed under Box 1 instead of under Box 3.

A change in Box 3 has been announced to bring the notational yields more in accordance with the economic reality.

Non-resident individuals

Non-resident individuals investing in Dutch property are taxed in a similar way to resident individuals. Hence, also non-resident individuals could be subject to Dutch taxation on any of the three “boxes” over income related to the property.

Real estate transfer tax

The acquisition of property located in the Netherlands is, in principle, subject to a 6% real estate transfer tax on the fair market value of the property at the time of the acquisition (2% on residential property). The rate for non-residential properties will increase to 7% from 2021. The transfer tax is levied on the acquirer of the property.

For Dutch real estate transfer tax purposes, the acquisition of the beneficial ownership of Dutch property is also subject to real estate transfer tax.

If the acquisition of property (full ownership or beneficial ownership) takes place within six months after a previous transfer of the same property, the taxable basis is reduced by the amount on which real estate transfer tax (or VAT that was not recoverable) has been paid upon the previous transfer.

Various exemptions from real estate transfer tax exist. The main exemptions apply to acquisitions legally subject to VAT (obligatory), or mergers and internal (group) reorganisations. These exemptions are dealt with below.

To avoid accumulation of real estate transfer tax and VAT, the acquisition of property is not subject to real estate transfer tax if the transfer is subject to VAT (legally, not by means of a so-called “option request”), and the property is not used as a business asset. Please note that if the property has been used as a business asset for a period less than six months, under certain conditions an exemption can still apply.

This exemption for transfers subject to VAT is not applicable under the following conditions:

- The reimbursement paid for the property by the acquirer is less than the fair market value.
- The acquirer is not able to deduct at least 90% of the VAT on the purchase price.

The acquisition of property as a result of a legal merger or demerger is exempt from real estate transfer tax, provided certain conditions are met. The transfer of property within a group of companies is exempt from real estate transfer tax, provided that certain conditions are met. A company forms part of a group if at least 90% of its shares are owned by other group companies.

VAT

The basic concepts of the Dutch VAT system, such as taxable persons, nature of goods and supply of goods and services are in line with the sixth EU VAT Directive. The Dutch VAT regulations are, therefore, roughly comparable to those applicable in other EU Member States.

A taxable person is any person who regularly and independently carries out economic activities, ie, the supply of goods or services.

VAT rate

The general VAT rate is 21% (2020).

Supply of goods

For Dutch VAT purposes, the transfer of a property qualifies as a supply of goods.

The situation could arise that the legal title and beneficial ownership of a property is transferred to different purchasers by the same supplier. In principle, the same goods cannot be transferred twice. Therefore, either the transfer of the beneficial ownership or the legal title should qualify as a supply for VAT purposes. In this respect, it should be assessed to which purchaser "the right to dispose the property as an owner" is transferred.

With respect to rights in rem which entitle the holder thereof to use immovable property (for example leasehold) we note that the grant, transfer, modification, waiver or termination of such limited rights (excluding mortgage and ground rents) qualify as a supply for VAT purposes, provided that the value of the reimbursement with respect to these rights are not less than the fair market value of the property. If the reimbursement is less than the fair market value of the property, the grant, transfer, etc of the right is considered a service for VAT purposes (eg, the letting of immovable property, see further below).

VAT treatment transfer of property

The general rule is that the supply of immovable property is VAT-exempt. In that case, no VAT is due with respect to the supply of the property. However, the supply of a property is VAT taxed by law in case the supply constitutes the supply of:

- a new(ly) developed property, which supply takes place within two years after the property is taken into first use;
- a plot of land that qualifies as building land for VAT purposes.

The supply of a property is also VAT taxed if parties opt for a VATable supply. We note that parties can only opt for a VAT taxed supply if the buyer rightly declares that it will use the property for purposes which, in principle, allow at least 90% recovery of input VAT. Such an option can be included in the deed of transfer. This can also be achieved by filing an option request for a VATable supply with the tax inspector of the seller. The separate request is necessary in case the transfer (of for example beneficial ownership of the property) does not take place by notarial deed.

It could be beneficial for the seller of a property to opt for a VATable supply. As result of the VAT taxed supply of the property, the seller is entitled to recover the VAT incurred on disposal fees/(re)development costs. Furthermore, the VAT incurred on costs that are directly attributable to the VATable supply can be recovered. Due to the VAT taxed supply (as result of the option) a new VAT revision period commences. In that respect, we note that the purchaser could potentially have an objection to the option for a VAT taxed supply.

If seller and buyer opt for a VATable supply, there is in most situations a reverse charge mechanism applicable with respect to the VAT, which is due on the supply. This means that the buyer must account for the VAT, which is due on the supply (the supplier does not charge VAT), by reporting it as reverse charge VAT in its Dutch VAT return. The buyer can, in principle, recover the amount of reverse charge VAT as input VAT in the same VAT return. The reverse charge mechanism therefore brings along a cash-flow advantage for the buyer since there is no actual cash flow.

In case the transfer of a property qualifies as a transfer of a going concern, the transfer of the property is not subject to VAT (ie, no VAT charged). Provided certain conditions the transfer of a leased-out property qualifies as a transfer of going concern. We note that the transfer of a going concern regime is not applicable with respect to a sale and lease back transaction.

VAT treatment lease of property

In principle, the lease of (a unit of an) immovable property is VAT-exempt. However, parties can opt for a VAT taxed lease if certain conditions are met. To correctly opt for a VAT taxed lease the lease agreement should include the following:

1. the cadastral and local designation;
2. the phrase that the lease is VAT taxed;

3. a statement of the lessee that the leased space will be used for 90% VAT taxable activities;

4. the financial year of the lessee; and

5. the signature of the lessor and the lessee.

Please note that an option for a VAT taxed lease is only valid with respect to the lease of a specific (part of an) immovable property to a specific lessee and has a maximum retroactive effect of three months.

In principle, the lease of parking spaces is VAT taxed by law. However, if a tenant leases immovable property as well as parking spaces from the same lessor, the VAT treatment of the lease of the parking spaces follows the VAT treatment of the lease of the immovable property. Consequently, the lease of parking spaces could be VAT-exempt.

If a lessor of Dutch immovable property is established outside the Netherlands, the Dutch VAT should in principle be reversed charged to the lessee of the property. Consequently, the invoice should include the words 'reverse charged'. In this respect, the lessee should account for reversed charged VAT in its Dutch VAT return.

VAT recovery

With respect to the VAT recovery right, we note the following:

- VAT on general costs incurred (ie, not property related) should in principle be recovered according to the VAT recovery percentage based on the total turnover figures of the VAT taxable person;
- VAT on costs incurred allocable to a single property can be recovered according to the VAT recovery percentage based on the turnover figures of that property. However, the VAT recovery percentage based on square meters could also be applicable if that ratio represents the actual use of these costs incurred more accurately than the VAT recovery percentage based on turnover figures. This recovery right is based on the total VAT taxed leased square meters divided by the total lettable square meters of the property;
- VAT incurred on (exploitation) costs directly attributable to a VAT taxed lease can be fully recovered;
- VAT incurred on costs directly attributable to a VAT-exempt lease is not recoverable.

If a VAT revision period is applicable with respect to a property, the VAT recovery right should be recalculated based on changes in the lease situation for each fiscal year of the VAT revision period and revise the unjustly recovered or non-recovered VAT in its last VAT return of that fiscal year. Depending on the changes in the VAT taxed and VAT-exempt leases this could result in an additional amount payable.

Local taxes

Every owner or user of properties located in the Netherlands is liable to local levies, such as property tax (except for users of residential real estate) and land draining rights. These taxes are usually based on the fair market value of the property. The local authorities are responsible for the determination of the value of the property (WOZ value). The local authorities must base the taxation of the value of the property on the Property Valuation Act.

Based on the Property Valuation Act, all properties located in the Netherlands are valued every year. The Property Valuation Act stipulates the valuation rules. The value of the property is set on the value that the property has on the reference date. The value reference date for the year 2020 is 1 January 2019. In determining the value of the property, elements that may influence the value of the property, such as rent, long lease rights and rights of usufruct are not considered. By fiction it is assumed that the property is empty and can be put into full use immediately.

Besides general valuation rules, the Property Valuation Act also provides rules concerning the valuation methods. For non-residential property (such as office buildings) this is the fair market value. According to the Property Valuation Act, the value of the property is based on the adjusted replacement value if this value exceeds the fair market value of the property. The adjusted replacement value is mainly used in situations in which it is difficult to determine the fair market value of a property. In some cases, it is very likely the value will be determined using the adjusted replacement value method. The adjusted replacement value method consists of the investment value (if the property is built from scratch) adjusted with the technical and functional correction for the obsolescence and potential dysfunctionality of the property. Also, an equipment exemption is applicable if certain conditions are met. Whether the equipment exemption is applicable, it is necessary to have information about the specific activities that are carried out in the building.

The WOZ value of the property will be stated in a formal decree. The value as stated in the decree will be applicable for a period of one year. The WOZ value for the year 2020 is determined on the basis of market prices on the reference date 1 January 2019.

The WOZ value stated in the decree is the basis for levying real estate taxes. The WOZ value is also used as a starting point for assessing the cap in depreciation in the corporate income tax for buildings. It is therefore important to review this value very closely and to preserve rights, to file an objection against the decree.

The municipal tax authorities will levy real estate taxes. Also, during the construction time, the municipal authorities will levy real estate taxes. The basis for taxation in this period will be the situation as from 1 January of each year. This means that the amounts payable of real estate taxes will increase during the construction period.

Each municipality is entitled to determine its own tariffs for real estate taxes from owners and users of property for tax year 2020. As of 2009, the real estate tax is determined on a pre-specified percentage of the total WOZ value. The average owner tariff for residential properties for the real estate tax is 0.1216% of the total value for the tax year 2020. The average owner tariff for non-residential real estate for the real estate tax is 0.2585% of the total value for the tax year 2020. In determining the tax base for the property tax for the user, the value of residential properties and residential parts of a property will not be considered. For users of non-residential real estate, the average tariff for the year 2020 is 0.1980% of the total value.

Other taxes and charges

Besides real estate taxes, local authorities levy other taxes and charges.

Building charges

The costs that the local government incurs in relation to the building permit that has to be obtained can be charged to the person requesting the permit. Usually the charge is a percentage of the building costs. The levy of building charges can be very high, and a critical review is advised before payment is made.

Polder board taxes

Depending on the local polder board, land draining rights will be levied for the water quantity control in specific areas. Polder board taxes can be a fixed amount or a percentage of the WOZ value.

Wastewater pollution tax

The polder board levies a tax for the discharge of wastewater into the public sewage system. They also levy a tax for discharge of wastewater directly into surface water if the polder board is responsible for the water quality management. If wastewater is discharged into surface water in operation with the central government, the appointed bureau of the central government will raise a similar tax.

Sewage system tax

For the right to be connected to the sewer system, usually an annual low-fixed amount of tax is levied. The amount of the tax can also be calculated as a percentage of the WOZ value.

Landlord tax

With effect from 1 January 2014, a landlord taxation is imposed on the lease of housing in the regulated (ie, so-called “social”) sector. Houses in the non-regulated (ie, so-called “liberalised”) sector are excluded from the landlord taxation. These are houses with a monthly rent of more than 737.14 EUR (2020).

Landlords of homes in the regulated sector must pay a levy of 0.562% (2020 and 2021) on the WOZ-value of these homes. The landlord taxation is levied on both domestic and foreign taxpayers. The measure does not apply to landlords who rent out 50 homes or less. In case the number exceeds 50, the 50 houses can be deducted as threshold.

Other taxes

Other optional taxes are for example the road management tax, business improvement district tax, the refuse matter tax and the energy tax.

Acquisition of a Dutch property company

Companies or individuals wishing to invest in Dutch property may also acquire the shares in a company owning property rather than making a direct purchase of the property. From a tax point of view, this choice may have a significant impact for both the seller and the purchaser.

Given the fact that the company may have a (tax) history and contingent liabilities it is generally advisable to conduct a due diligence review of the target company. In such a due diligence, eg, the legal, corporate tax, VAT and transfer tax position of the company should be checked.

If necessary, the seller of the company should be asked for certain guarantees on the (tax) position of the company.

Corporate taxes

Resident companies

If shares in a BV or NV company owning property are acquired by another Dutch BV or NV company, the latter company must value the shares in the acquired company at the historic acquisition price. Contrary to a direct purchase of property, the purchaser of the shares in a BV or NV company owning Dutch property will not benefit from any step-up in value of the property, because for corporate tax purposes, the company owning the property must continue to value the property at the original acquisition price (minus depreciation). Hence, the fiscal book value of the underlying property will remain the same and the annual depreciation will be lower compared to a direct purchase of property.

Note that if a hidden increase in value is included in the fiscal book value of the property, the price negotiated for the acquisition of the shares is typically reduced by the net present value of the deferred corporate tax claim on the hidden reserves.

If the shares in a company owning property are acquired by a Dutch BV or NV company or a Dutch permanent establishment (PE) to which the shares in the company belong, the future dividends distributed by the property company to the BV or NV shareholder or PE are in principle exempt from Dutch corporate tax under the participation exemption rules. Also, capital gains realised on the sale of the shares in a property company are in principle exempt under the participation exemption.

The Dutch participation exemption applies if the company holds at least 5% of the shares of the subsidiary company and certain other conditions are met. Should the participation exemption apply, dividends and capital gains realised by the shareholder are exempt, unless these payments were deductible at the level of the subsidiary.

The Dutch participation exemption as a main rule will be applicable to subsidiary companies that are intended not to be held as a portfolio investment (“intention” test). A subsidiary that is held as portfolio investment can however be regarded as a “qualifying portfolio investment participation” in case either the ‘asset’ test or the “effective tax rate” test is met.

A subsidiary is considered a qualifying portfolio investment participation if the subsidiary’s aggregated assets usually consist of less than 50% “low taxed passive investments”. Generally speaking, such assets are assets that generate passive income such as interest, royalties and rental income. Real estate assets will by definition be “good assets”, as a result of which the participation exemption should apply to subsidiaries investing more than 50% in real estate, irrespective of whether the “intention” test or the “effective tax rate” test is met or not. Under the “effective tax rate” test, the participation exemption will be applicable to subsidiaries that are subject to a profit tax resulting in a real (reasonable) levy of tax according to Dutch tax principles. A profit tax rate of at least 10% over a tax basis in accordance with Dutch tax accounting principles is a real levy of tax.

Likewise, losses resulting from a participation in a subsidiary company are generally not deductible. Under certain circumstances, losses incurred upon the liquidation of the subsidiary company are deductible at the holding company level.

Losses can be offset against any other taxable income generated by the BV or NV company in the same year. The carry back of tax losses is limited to one year. Carry forward of tax losses is limited to six years. However, losses incurred by a “pure holding” or “group finance” company can only be offset against profits in other years, provided that the company qualifies as a ‘pure holding’ or ‘group finance’ company in such other year and the balance of the loans to and from related parties is not higher than in the year the loss was realised.

Moreover, if the ultimate control in the taxpayer is changed by 30% or more, the possibilities available to offset tax losses may be limited.

For a detailed description of the application of the change of control rules, see section "*Direct investments in Dutch property*".

Non-resident companies

For non-resident companies acquiring shares in Dutch BV or NV companies, in principle, the same rules apply as for Dutch resident companies.

As a main rule, dividends distributed by a Dutch resident are subject to Dutch dividend WHT at the rate of 15%. There is no dividend WHT on dividends distributed within a fiscal unity for corporate income tax purposes. In addition, no dividend WHT is due on dividends if the conditions of the participation exemption for dividend WHT purposes apply. Briefly, this should be the case if the recipient of the dividends (i) is a resident of the EU, EEA or part of the Netherlands has concluded a DTT that includes a dividend article or a state within the Kingdom of the Netherlands and (ii) would have been able to apply the Dutch participation exemption or participation credit to the dividend if it would have been resident of the Netherlands (ie, has an interest of at least 5% in the Dutch BV or NV) and no specific abuse situation applies. The Dutch dividend WHT rate may also be reduced under the DTT concluded by the Netherlands.

Gains from the sale of shares in a Dutch real estate company by a non-resident corporate investor is – apart from specific abusive situations – not subject to corporate income tax in the Netherlands. The same applies to dividends received by a non-resident company from a Dutch company. However, such dividends and capital gains are subject to the maximum rate of 25% Dutch corporate tax if the foreign shareholder has an interest of at least 5% and holds the shares in the Dutch company with the main purpose or one of the main purposes to avoid Dutch personal income tax while an arrangement (or series of arrangements) has been applied which is not based on sound business motives which reflect economic reality.

Furthermore, it has been announced that the legislator is considering implementing a conditional WHT on dividends paid to low tax jurisdictions or non-cooperative countries from 2024.

Personal income tax

The income of Dutch individuals is allocated to three "boxes". Each of these boxes has a separate tax treatment (see section "*Direct investments in Dutch property*/*Personal income tax*").

Resident individuals

Dutch resident individuals who hold, alone or together with their spouses, 5% or more of the shares in a BV or NV company owning property are considered the holder of a substantial interest for Dutch personal income tax purposes. Note that if a person has a substantial interest as defined above, then certain other relatives owning less than 5% will also be considered as a holder of a substantial interest.

Benefits derived from the substantial interest by Dutch resident substantial interest holders fall under Box 2 and are subject to a flat 26.25% tax rate (2020). These benefits include the following:

- dividends or profit rights;
- capital gains realised on the transfer of shares or profit rights; and
- capital gains realised on the transfer of options granting the right to buy shares, profit rights to the BV or NV.

If a substantial interest holder makes property available (eg, by way of renting) to the company in which the substantial interest is held, the actual income is taxed under Box 1 instead of under Box 3. Furthermore, income or capital gains from loans provided by a Dutch resident individual or a related party to the BV or NV company in which a substantial interest is held is taxed under Box 1 instead of Box 2.

Dutch resident individuals who hold less than 5% of the shares in a Dutch BV or NV company owning Dutch property are not considered holders of a substantial interest. Income derived from such a shareholding is subject to the capital yield tax of Box 3. The income will be calculated on the basis of three ascending fixed percentages and taxed against a flat rate of 30%. These percentages have been determined on the basis of relevant market information and investment results and will be reassessed periodically. For 2020, the percentages range between 1.79 and 5.28% (see section "*Direct investments in Dutch property*/*Personal income tax*/*Resident individuals*" above).

Dividend distributions by a Dutch company to its Dutch resident individual shareholders are subject to a 15% dividend WHT.

The dividend WHT is fully creditable against personal income tax, both for substantial interest holders and non-substantial interest holders.

Non-resident individuals

Non-resident individuals who hold 5% or more of the shares in a Dutch BV or NV company will also be considered the holder of a substantial interest and will be considered a non-resident taxpayer for Dutch personal income tax purposes. Non-resident substantial interest holders are, in principle, subject to the tax rate of 26.25% (Box 2, refer above) applicable on dividends, capital gains, etc, similar to Dutch resident substantial interest holders. DTTs may limit the right for the Netherlands to levy Dutch income tax on substantial interest income and gains.

The 15% WHT on dividends, which may be limited under the DTTs concluded by the Netherlands to the reduced DTT rates, can be credited against Dutch income tax levied (if any) on the dividends received.

Non-resident individuals who are not considered holders of a substantial interest are not subject to Dutch personal income tax. However, the Netherlands will levy a 15% dividend WHT on dividends distributed by a Dutch BV or NV company to these shareholders. The WHT rate may be reduced under a DTT.

The Netherlands does not levy any WHT on capital gains realised by non-resident individual shareholders on the sale of the shares in a Dutch BV or NV company.

Real estate transfer tax

In principle, the acquisition of shares in a company owning Dutch property is not considered to be an acquisition of property itself and is, therefore, not subject to Dutch real estate transfer tax.

However, a company of which property accounts for at least 50% of the assets while Dutch property accounts for 30% of the assets of the company is generally considered a property company for real estate transfer tax purposes. The acquisition or expansion of on interest of one-third or more is subject to 6% real estate transfer tax (2% on residential property) on the proportionate part of the fair market value of the property (directly or indirectly) represented by the interest acquired. The rate for non-residential properties will increase to 7% from 2021.

If the acquisition of shares in a property company (full title or beneficial ownership) takes place within six months after a previous transfer of the same shares or the property represented by the shares, the taxable basis is reduced by the amount on which real estate transfer tax was due upon the previous transfer.

The following anti-abuse provisions apply:

- A reference period applies, which is intended to prevent the asset side of the company's balance sheet from being inflated in the context of a transfer of shares as a result of which the transaction would be exempt from transfer tax.
- Assets and liabilities of subsidiary companies in which a parent company holds a direct or indirect interest of at least one-third are allocated to the parent company in proportion to the interest (proportional consolidation).
- The shares that are being held or acquired by companies and natural persons affiliated with the party acquiring the shares will be considered when determining whether or not a qualifying interest is acquired.

Note that if an acquiring person has acquired an interest in parts, it will be liable to pay transfer tax on prior acquisitions of shares if these prior acquisitions and the acquisition at hand jointly lead to a qualifying interest and the prior acquisitions were made within a period of two years preceding the current acquisition at hand.

VAT

The acquisition of shares is VAT-exempt. The VAT on relating (advisory) costs for this acquisition of shares can, in principle, be recovered in accordance with the VAT recoverable percentage that is applicable on general costs.

If the acquisition of shares is ultimately unsuccessful (ie, the shares will not be acquired), the VAT on acquisition costs incurred can generally be recovered, provided there is an objective intention to render VATable services/supplies to the target.

Investing in Dutch property through a partnership

Generally speaking, the main benefit of using a partnership (such as a Dutch *maatschap* or a *commanditaire vennootschap*) for the investment in property, as opposed to a Dutch BV or NV company, is that while often providing for limited liability (such as for the limited partners in a *commanditaire vennootschap*), the partnership may be structured as a tax transparent entity for Dutch tax purposes. A transparent partnership structure provides for a direct allocation of profits and losses to the partners, avoiding multiple level (corporate) taxation.

A further benefit compared to investing through a Dutch BV or NV company is that depending on the facts and circumstances, a private individual partner may benefit from the Box 3 capital yield tax regime, under which regime capital gains realised on the disposal of the property are not taxed.

For Dutch corporate and income tax purposes, a Dutch partnership investing in Dutch property is generally considered a transparent entity if the admission and replacement of partners is subject to the prior written approval of all other partners.

A direct consequence of the transparent character of the partnership is that, rather than the partnership itself, the participants of the partnership are subject to Dutch corporate or personal income tax. For (corporate) income tax purposes, this means that:

- All assets and liabilities of the partnership are directly allocated to the partners.
- All partners must report their share of the income derived by the partnership in their own Dutch tax return.

Corporate tax

Resident companies

A Dutch BV or NV company holding an interest in a partnership owning Dutch property is subject to taxation on all income realised by the partnership that is attributable to its share. Hence, rental income (ie, gross rental income minus allocable expenses and depreciation) and capital gains realised are attributable to the corporate participant and are subject to corporate tax at the ordinary corporate tax rate.

Non-resident companies

The Dutch taxable income of a non-resident company holding an interest in a partnership is subject to the ordinary Dutch corporate tax regime and tax rates.

Hence, the income and capital gains realised by the partnership, which are attributable to its partnership share are taxed in the same way as that of Dutch resident companies.

Personal income tax

The income of Dutch individuals is allocated to three "boxes". Each of these boxes has a separate tax treatment (see section "*Direct investments in Dutch property*/*Personal income tax*").

Resident and non-resident individuals

In principle, individuals (resident or non-resident) holding an interest in a partnership investing in Dutch property will be subject to the capital yield tax (Box 3) calculated over their proportionate interest in the assets and liabilities of the partnership (see section "*Direct investments in Dutch property*/*Personal income tax*").

Real estate transfer tax

The acquisition of Dutch property by a partnership is, in principle, subject to Dutch real estate transfer tax under the same rules as a direct acquisition of Dutch property.

The acquisition of an interest in a partnership – without legal personality – holding Dutch property is in principle subject to 6% real estate transfer tax (2% on residential property) on the proportionate share of the fair market value of the property at the time of the acquisition, irrespective of the size of the acquired interest. The rate for non-residential properties will increase to 7% from 2021. However, no real estate transfer tax is due with respect to the acquisition of an interest of less than one third in an entity without legal personality (such as partnerships under Dutch law) that qualifies as "investment fund" as defined in the Financial Markets Supervisory Act. However, if the partnership has legal personality, the partnership might be treated as a real estate company. In that case transfer tax is only due if an interest of one-third or more is acquired or expanded (see section "*Acquisition of a Dutch property company*/*Real estate transfer tax*") on the fair market value of the (underlying) Dutch real estate properties held by the company, pro rata the size of its interest.

VAT

The transfer of Dutch property to a partnership is considered as a supply for VAT purposes to which the normal VAT rules for the supply of Dutch property apply. Please note that for VAT purposes the partnership may be

treated as a separate taxable person. This means separate VAT registration and filing of VAT returns. For the normal VAT rules, see section "*Direct investments in Dutch property/VAT*".

Dutch REIT (FBI)

Dutch tax law provides for a tax regime that is similar to the regime applicable to real estate investment trusts (REIT) in other jurisdictions. This regime is referred to as FBI (*fiscale beleggingsinstelling* or "fiscal investment institution") and can be applied by a Dutch BV, NV or fund for joint account (or a comparable entity under foreign law) provided certain conditions are met. A qualifying FBI is subject to a corporate income tax of 0%. In order to qualify as an FBI, certain strict conditions must be met, among others: shareholder requirements, a profit distribution requirement, an "activity" test and certain leverage conditions. Dividends distributed by an FBI are subject to the regular 15% dividend WHT.

Another regime applicable to non-transparent investment companies or funds is the so-called "exempt investment institution" (*vrijgestelde beleggingsinstelling*, or VBI). The VBI is exempt both from Dutch corporate income tax and from Dutch dividend WHT. The VBI may only invest in so-called "financial instruments" and cannot invest in Dutch real estate directly.

Financing the acquisition of Dutch property

Equity financing

In the Netherlands no capital duty is applicable.

Debt financing

Corporate tax/Personal income tax

Interest paid on loans taken out to acquire property or shares in a property company is, in principle, fully tax-deductible, provided that the loan is granted under at "arm's length" terms (ie, as if granted by a third party). General transfer pricing principles do apply.

If a loan is taken out from a related party, whereas upon granting of the loan it is clear that the debtor will not be able to repay the debt, the loan may be requalified as capital and the interest may not be deductible. If a loan is established between related parties while the debtor's risk would not be accepted by a third party granting the loan, Dutch case law may result in the non-deductibility of the future write down of the loan. Also, on the debtor side the creditors risk may be disregarded resulting in a disallowance of the risk premium in the amount of deductible interest.

If, real estate is held as an investment by a private individual, the so-called "capital yield tax" of Box 3 does generally apply. In that case, loans taken out by the private investor reduce the taxable base for the purpose of the capital yield tax. The interest paid or accrued on these loans is not tax-deductible.

Limitations on deductibility of interest

Anti-abuse rules may limit the deductibility of interest paid on certain loans taken out by corporate taxpayers.

Base erosion rules

The limitation on the deductibility of interest, inter alia, effects interest paid on related party debts (directly or indirectly) in respect of:

- dividends and repayments of capital declared but unpaid;
- dividends and repayments of capital declared and paid when financed through a loan granted by a related entity or related person;
- capital contributions into related companies;
- the acquisition of shares in a company as a result of which the target company becomes a related entity.

A related entity in this respect is defined as:

- an entity in which the taxpayer holds an interest of at least one-third;
- an entity that holds an interest of at least one-third in the taxpayer;

- an entity in which a third party holds an interest of at least one-third, while this third party also holds an interest of at least one-third in the taxpayer.

A related person in this respect is defined as a natural person who holds an interest of at least one-third in the taxpayer or a related entity of the taxpayer. For the purpose of the above related party test the term “interest” refers to an (in)direct financial interest, an (in)direct interest in the control or a combination thereof.

The interest deduction is not denied if the taxpayer can demonstrate that the loan and the underlying transaction are based predominantly on sound business considerations.

If the debtor and the creditor are related parties and have entered into a loan agreement that has no fixed maturity date or has a term of more than ten years and either no interest is agreed upon or the interest rate is significantly lower (30% or more) than the interest that would be charged on similar loans between non-related parties, the interest and devaluation of the loan are not tax-deductible. If the term of the loan is extended, the loan is deemed to have that term from the date of the original agreement.

These rules regarding the deductibility of interest are very complex and it is essential to consider the rules carefully in respect of specific transactions to ensure deductibility of interest.

Hybrid loans

Under certain circumstances a loan is treated as a hybrid loan for Dutch tax purposes. A loan is considered to be a hybrid loan for Dutch corporate income tax purposes in the following circumstances:

- The interest fully depends on the profits of the debtor.
- The term of the loan exceeds 50 years, or the loan has no term but is only repayable upon bankruptcy, suspension of payment or liquidation of the debtor.
- The loan is subordinated to all other creditors.

When a loan is considered to be a hybrid loan, the tax consequences are as follows:

- Interest paid on a hybrid loan and revaluations of the principal are not tax-deductible by the debtor.
- A hybrid loan is deemed to be a participation under the participation exemption provisions if the creditor or a related party already owns a qualifying shareholding in the debtor. This means that interest on such loans and revaluations thereof are tax-exempt.
- The debtor must withhold dividend tax from interest paid on hybrid loans.

Written-down receivables

The following corporate tax provisions apply in relation to written-down receivables (bad debts):

- compulsory profit recognition for tax purposes by the Dutch creditor in the event of a waiver or conversion into shares of written-down receivables owed by an affiliated debtor. The same tax treatment applies if the circumstances in respect of the debt are changed such that its de facto serves as quasi-equity of the formal debtor. Under certain conditions it is possible to postpone taxation on such profit recognition. The compulsory profit recognition does not apply in the event that a Dutch creditor company waives a bad debt, provided that this triggers the recognition of a taxable profit in the hands of the debtor company, which is subject to an effective tax rate of at least 10% over taxable profits determined according to Dutch standards.
- compulsory profit recognition for tax purposes by the Dutch creditor in the event of assignment, disposal or transfer to an affiliated company of written-down receivables owed by a debtor/affiliated company.

Non-business-like loans

Furthermore, the Dutch tax authorities more often question the nature of a loan between affiliates on the basis of Dutch tax case law regarding “non-business-like loans” (*onzakelijke leningen*). A “non-business-like loan” could exist to the extent that based on the terms and conditions under which the loan has been provided, a creditor’s risk is taken which a third party would not have taken. To the extent a loan qualifies as a “non-business-like loan”, part of the tax deduction of the related interest may be denied to the extent the interest on the loan is higher than an “arm’s length” party would have charged if the creditor would have provided security over the loan. Further, a potential impairment loss on the ‘non-business-like-loan’ at the level of the creditor (if this is a Dutch tax resident legal entity) is not deductible for Dutch corporate income tax purposes.

Earnings stripping rule (ATAD I)

In June 2016, the EU Member States agreed on the so-called Anti-Tax Avoidance Directive (ATAD). Part of the ATAD is the introduction of a provision that limits the deductibility of interest. This has resulted in the introduction of the earnings stripping rules from 2019 in the Netherlands. The rules comprise of limitation of the deduction of interest expenses if the net-interest expenses are in excess of 30% of taxpayer's EBITDA. A threshold of 1 million EUR of net-interest expenses will be deductible, regardless of the taxpayer's EBITDA. Any non-deductible interest can be carried forward indefinitely.

The ATAD provides EU Member States with the option to implement several exceptions to the EBITDA rule. These options include: (i) grandfathering for interest expenses on existing loans, (ii) a group escape mechanism whereby interest is still deductible if certain group ratios are met, (iii) an exemption for interest paid in relation to long-term infrastructure projects and (iv) an exemption for financial institutions. The Dutch government has opted to provide for a grandfathering rule for existing private/public cooperation projects but has decided not to include these other exceptions in Dutch law.

Anti-hybrid rules (ATAD II)

On 1 January 2020, further rules under ATAD were implemented in the Netherlands. This implementation concerns the implementation of amendments made to ATAD, referred to as ATAD II. These amendments have been implemented to neutralise payments between associated entities that result in a hybrid mismatch. A hybrid mismatch is a different qualification of income, payments or entity in two or more jurisdictions. To be in scope of ATAD II, the mismatch must result in a deduction/non-inclusion or double deduction. The affected payments are not limited to interest expenses (both third party and related party interest). Royalties and management fees may also be affected, as well as tax depreciation and even third-party expenses, depending on the situation. The Dutch ATAD II rules affect hybrid mismatches between associated entities, ie, with an interest of at least 25% or more in a taxpayer (alone, together with related entities or "acting together"). In the Netherlands, "acting together" must be interpreted in accordance with the collaborating group principle (as introduced in Article 10a of the Dutch Corporate Income Tax Act). It should be assessed based on the facts and circumstances whether investors are considered to be acting together. Structured arrangements between unrelated parties are also covered by the ATAD II rules (eg, transactions that are part of an avoidance scheme).

A mismatch resulting in a deduction/non-inclusion involves fees or payments that are tax-deductible in the jurisdiction from which these fees or payments originate (state of the payer) and where such fees or payments are not included in any other state where such fees or payments are received or deemed to be received (state of the recipient). A mismatch resulting in double deduction involves the same fees or payments that are tax-deductible in the jurisdiction from which these fees or payments originate (state of the payer) and are also tax-deductible by or pursuant to the laws of at least one other state. Furthermore, if a jurisdiction fails to (adequately) tackle a mismatch from a Dutch perspective that is indirectly involved in the mismatch, then the Netherlands must deny the deduction of the payment that is indirectly involved in the mismatch ("imported mismatch").

The neutralisation measure of ATAD II has a primary and secondary rule. As a result of the primary rule, the deduction is denied in the source state. In the case of double deduction, the deduction is denied in the investor state rather than the source state. If the primary rule fails to adequately neutralise the hybrid mismatch (eg, because the source state is located in a third country), the secondary rule kicks in, whereby the payment is included in the income of the investor. For double deduction scenarios, the secondary rule prevents deduction in the source state. Both measures are based on an "insofar approach", whereby deduction is only denied (primary rule) or income is only included (secondary rule) insofar these result in deduction/non-inclusion or double deduction.

The Dutch ATAD II rules introduce a so-called "origin test" (*oorsprongseis).* Based on this test, the neutralising measures of the Dutch ATAD II rules do not apply if deduction/non-inclusion is not effectively caused by a hybrid mismatch, but rather by another factor. This is generally the case for payments to an entity that is not subject to corporate tax. In such case, the deduction/non-inclusion would have occurred regardless of the hybridity of the payor or payee. It is not explicitly mentioned that the "origin test" also applies to a double deduction scenario. Based on a reasonable application of the law, this is however expected to be the case.

The primary or secondary rule can be – wholly or partially – mitigated under the dual inclusion income escape. This escape applies if the payment in scope of the primary or secondary rule is effectively included in both the investor jurisdiction and the jurisdiction of the payer. The Dutch ATAD II rules require income to be effectively included in the taxable base in those countries between which a deduction/non-inclusion or a double deduction arises. The Dutch escape only applies insofar the income is effectively included twice (*feitelijk in beide staten in de heffing betrokken*). Also, the mere expectation that the income will also be included in the other state in a future year does not make the income dual inclusion income.

From 1 January 2022, the reverse hybrid rule will be introduced. The reverse hybrid rule introduces a tax liability for Dutch entities that are deemed transparent/flow through for Dutch corporate tax purposes, if investors holding an interest of at least 50% in the Dutch entities deem such entity non-transparent/corporate from a local tax perspective.

VAT

The financing of property with a (mortgage) loan is VAT-exempt.

Withholding tax

The Netherlands does currently not levy WHT on interest payments, with the exception of certain hybrid debts. Also, currently no WHT is levied on royalty payments

From 1 January 2021, a conditional WHT on interest and royalty payments to affiliated entities resident in a low-tax or non-cooperative jurisdiction will be introduced. The conditional WHT will also apply in abusive situations and situations involving hybrid entities or permanent establishments. The WHT will be levied at a rate equal to the highest corporate income tax rate (21.7% in 2021).

Entities are affiliated in a situation in which the shareholder can – directly or indirectly – exercise a decision-making influence. In any event, this is the case if the shareholder has more than 50% of the voting rights under the articles of association. Such interest may be held on a stand-alone basis or together with a collaborating group *(samenwerkende groep*). The definition of a collaborating group is not set out by law and depends on the facts and circumstances of the case at hand. For conditional WHT purposes, a collaborating group is deemed to exist if a coordinated investment is made by entities part of the same group that jointly have a qualifying interest, ie, more than 50%.

The conditional WHT applies to payments made to entities is designated low-tax jurisdictions. Low-tax jurisdictions are jurisdictions with a statutory corporate tax rate of less than 9% and jurisdictions on the EU list for non-cooperative jurisdictions. Current listed countries include, among others, Bahamas, Belize, Bermuda, British Virgin Islands, Cayman Islands, Guernsey, Jersey, Marshall Islands, Trinidad and Tobago, and US Virgin Islands. The Dutch list of low-taxed jurisdictions is updated annually on 1 October and is applicable to the following year.

Apart from direct payments made to affiliated entities in the above-mentioned jurisdictions, the conditional WHT may also apply to abusive situations. Abuse situations are defined as situations where artificial structures are put in place with the main purpose or one of the main purposes to avoid the levy of Dutch conditional WHT, eg, where an interest payment to a relevant jurisdiction is artificially routed via a low-substance financing entity in a “good” jurisdiction. Accordingly, for each interest and royalty payment to an affiliated entity it must checked if an artificial structure is put in place and the main purpose of the structure must be tested. A transaction or structure may be regarded as artificial if the structure is put into place without business motives that reflect economic reality. If the relevant substance of the recipient reflects the business motives of the structure, then this may be an indication that the structure is not artificial. However, the tax authorities may – considering the facts and circumstances – still be able to state that the structure is artificial regardless of the substance at the level of the recipient.

Further, conditional WHT is also levied in cases where the recipient of the interest does not recognise itself as the recipient of the payment, ie, either because that entity is locally deemed as transparent whilst being deemed opaque from a Dutch perspective or the payment is locally allocated to an entity the recipient has an interest in. For these situations, certain exemptions from the conditional WHT may be available.

The conditional WHT is in principle levied from the entity that makes the interest or royalty payment and that withholds the conditional WHT. However, if the conditional WHT has not been applied correctly, the tax inspector may also issue an additional tax assessment to the recipient of the interest or royalty payment. In order to ensure that the correct amount of tax is paid, directors of the withholding company may also be held liable for the (timely) payment of the correct amount of WHT. However, a director is not liable insofar he can show that it is not his fault that the correct amount of WHT was not paid.

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Turkey

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All information used in this content, unless otherwise stated, is up to date as of 27 July 2020.

Real Estate Tax Summary

General

According to Article 35 of Land Registry Law No 2644 (the “Law”), in principle, foreign individuals may acquire immovable assets. Before 18 May 2012, such acquisition was subject to the conditions provided under the Law. The respective conditions were as follows:

- existence of reciprocity between Turkey and the respective country of the individual wishing to acquire real estate; (both de jure and de facto);
- the total size of the real estate acquired or in which an interest is acquired will not exceed 2.5 hectares; and
- the total size of real estate to be acquired in one city will comply with any restrictions on size imposed by the Council of Ministers for that particular city.

On the other hand, Law amending the Land Registry Law has been published in the Official Gazette dated 18 May 2012 and numbered 28296 (the “Amendment”) with the following amendment:

- The reciprocity principle provided under Article 35 of the Law has been abolished. Therefore, foreign individuals may acquire real estates in Turkey without complying with the reciprocity principle as of 18 May 2012. The President of the Republic has been determined as the competent authority to determine the nations of whose citizens may acquire real estate in Turkey with the 9th amendment provision of the Executive Order No 698 dated 2 July 2018; and
- The area threshold provided under Article 35 of the Law has been expanded. With the Amendment, the total size of the real estate acquired, or an interest acquired by the foreign individual has been limited to 30 hectares nationwide and 10% of the district where the real estate is located.

The conditions for application to Turkish citizenship by way of real estate ownership were softened by a number of amendments to the Regulation on the Implementation of Law of Turkish Citizenship, which were published on 19 September 2018. These amendments lowered the threshold purchase price for eligibility to 250,000 USD. With a new amendment to the same regulation, which was published on 7 December 2018, it became possible to apply for Turkish citizenship before title deed has been obtained.

Per the new amendment, Turkish citizenship applications will be permitted on the basis of a promise to sell agreement, so long as the agreement has been signed before a notary public; a condominium regime has been established for the property being purchased; at least 250,000 USD or its equivalent in a different currency has been paid in advance; and the agreement has been recorded at the land registry with the undertaking not to assign or de-register the agreement for a period of three years.

Also, as per the regulation published in in the official gazette on 19 September 2018, the minimum threshold for real estate investment trust and venture capital investment fund contributions has been reduced from 1,500,000 USD to 500,000 USD.

In principle, foreign legal entities are not allowed to acquire real estate in Turkey. The only type of foreign legal entity that might acquire real estate in the country is a foreign trading company. Other foreign legal entities, such as charities, foundations, societies and funds, are not allowed to obtain real estate.

Furthermore, foreign legal entities incorporated under the laws of a foreign country may acquire real estate in Turkey, only if such acquisition is allowed under the specific laws, ie, Petroleum Law, Tourism Encouragement Law.

On the other hand, establishing a company that will be resident in Turkey in order to acquire real estate or limited real right is also subject to some restrictions according to Article 36 of the Land Registry Law. Companies established in Turkey by foreign investors are deemed to be Turkish companies, but their acquisition of real estate and limited real rights in Turkey have been restricted by the decision of Constitutional Court on 11 March 2008 to cancel Article 3(d) of the Foreign Direct Investment Law, which offered equal terms and conditions in acquiring real estate to both (i) a national company with a domestic capital, and (ii) companies established in Turkey by foreign investors.

According to Article 36 of the Law, companies established in Turkey by foreign investors may acquire and use real estate ownership or limited real rights in order to achieve objectives set out in their articles of association. The same principle applies to a transfer of the real estate to another foreign capitalised company established in

Turkey, or in a case where a national company with domestic capital owning a real estate becomes a foreign capitalised company by means of a share transfer transaction.

Real estate acquisitions by these types of companies in military forbidden zones, security zones as well as in strategic zones are subject to the permission of the Turkish General Staff or commandership to be authorised by the General Staff, whereas such acquisitions in private security zones are subject to the permission of the relevant local governorship. Permission depends on how well the acquisition is seen to conform to the country's safety and the company's scope of activity. The decision is, therefore, taken by a commission appointed within the governorship representing the relevant administrations.

Article 36 also provides that any acquisition made in contravention of the Law will be liquidated by the Ministry of Finance, unless the owner liquidates the respective real estate within the given time limit by the Ministry of Finance. It is worth noting that the owner will be paying in cash after the liquidation process. Finally, a regulation has been issued by the Ministry of Public Works and Settlement, which regulates the terms and conditions of real estate acquisition by foreign capitalised companies within the framework of Article 36 of the Land Registry Law.

Taxation of rental income

Corporation tax

Net rental income acquired by resident corporate entities is taxable in Turkey. Rental income acquired by corporate entities is included in the annual corporate income tax (CIT) return, and is subject to 22% CIT (for 2018, 2019 and 2020; and for the following years at 20%).

Dividend withholding tax

Dividends when distributed to non-residents or individual shareholders are subject to withholding tax (WHT) at the rate of 15%. The rate may be reduced by virtue of bilateral treaties.

Determination of tax base

Tax deduction

Property-related costs, such as repair and maintenance, insurance and interest, are tax-deductible.

Taxpayers are free to include in the cost expenses for public notaries, court fees, assessments, commissions, and public announcements as well as for Real Estate Purchase Tax, or they can be considered as an expense in the determination of income.

Expenses included in the cost of real estate

Expenses arising from the purchase and demolition of an existing building and the levelling of its site are included in the cost, supplementary to the purchase price.

According to Article 272 of the Tax Procedural Law, expenses incurred in expanding real estate or increases in commercial worth (but excluding expenses for normal maintenance, repairs, and cleaning) are added to the cost of the real estate.

Depreciation

The applicable depreciation rates are between 2% to 10% for different types of buildings. However, all companies and those real persons who are obliged to keep their statutory books and financial tables on a balance sheet basis, can apply the declining balance method for depreciation. This means that the 2% to 10% depreciation rate becomes 4% to 20%. But, even with this method, the depreciation period cannot be shortened compared to the normal method.

Vacant land is not depreciable.

Taxation of capital gains

Taxation of capital gains derived by resident corporations

Profits of corporate taxpayers stemming from the sale of assets are included in the corporate tax base of the company and taxed at the normal CIT rate at 22% (for 2018, 2019 and 2020; and for the following years at 20%). There is no separate capital gains taxation.

In calculating the net capital gain by corporations, a special corporate tax exemption regulated under Article 5 of Corporate Income Tax Law can be used to eliminate taxation. However, this tool cannot be used by companies whose main or regular activity is property trading and/or leasing.

In accordance with this exemption, 50% of the capital gains derived from disposal of property are exempted from corporate income tax provided that the property is held for at least two years. In order to benefit from this 50% capital gains exemption, the sales profit must be booked in a special reserve account for at least five years. The exemption will be applied in the period in which the sale takes place. If the sales revenue is not collected within two years, or the related profit is withdrawn from the special reserve account or transferred to any account apart from the paid-up capital, the taxes not accrued on time will be claimed back with penalty.

Distribution of that income in any way or liquidation of the company within five years will lead to full taxation.

Moreover, the seller is also exempt from stamp tax under the above-mentioned corporate tax exemption.

VAT exemption is also applicable for the sale of properties held for at least two years according to the VAT Law. Again, this VAT exemption will not be applicable if the main or regular activity of the seller company is real estate trading. (Property sales by individuals who are not involved in any commercial activity are exempt from VAT.)

Taxation of capital gains derived by non-resident corporations

In principle, capital gains of non-resident entities from disposal of real estate are taxable in Turkey if the real estate is located in Turkey.

Capital gains are calculated as the positive difference between the sales price and the acquisition cost. Acquisition cost is indexed with monthly inflation rates for determination of net capital gains. The cost adjustment can only be made if the wholesale price index (WPI) is at least 10%.

Net capital gains calculated as such are subject to corporate income tax and dividend WHT as discussed above. Bilateral tax treaty provisions do not limit Turkey’s right to tax capital gains from disposal of real estates.

Taxation of capital gains by individuals

Capital gains of individuals from the sale of property are exempt from income tax provided that the related property has been owned for at least five years.

Capital gains are calculated as the positive difference between the sales price and the acquisition cost. Acquisition cost is indexed with monthly inflation rates for determination of net capital gains. However, the cost adjustment can only be made if the increase in the producer’s price index is at least 10%.

Furthermore, capital gains of individuals derived from the disposal of real estate property will not be taxed if the gross amount of such income does not exceed 18,000 Turkish liras (TRY), approximately 2,250 EUR at the current exchange rate.

Capital gains calculated as such are taxed at progressive tax rates varying between 15% and 40%.

Real estate related taxes

Value-added tax (VAT)

Under the Turkish tax system, liability for VAT arises:

- when a person or entity performs commercial, industrial, agricultural or independent professional activities within Turkey;
- when goods or services are imported into Turkey.

VAT is levied at each stage of the production and the distribution process. Although liability for the tax falls on the person supplying or importing the goods or services, the real VAT burden is borne by the final consumer.

This result is achieved by a tax-credit method where the computation of the VAT liability is based on the difference between the VAT liability of a person on this sale (output VAT) and the amount of VAT they have already paid on their purchases (input VAT).

Buying and selling of real estate is subject to Turkish VAT at 18%. However, there are certain VAT exemptions applicable for real estates. Available exemptions are listed below:

- selling of real estate by resident corporations that have held the property for at least two years (note that this exemption is not valid for companies whose main or regular activity is property trading);
- selling of real estate by individuals who are not estate agents;
- delivery of offices and factories that are built in organised Industrial Zones or small Industrial Villages; and
- selling of real estate property by the state.

Additionally, sale of residential units which are holding their building license before 1 January 2013 with a net area of less than 150sqm will be subject to 1% VAT. However, the effective VAT rate to be applied on the sale of residential units which are holding their building license as from 1 January 2013 with a net area of less than 150sqm, will be between 1%, 8% and 18% based on some conditions, such as:

- building license obtaining date;
- construction class of the building;
- square metres of the house;
- whether it is built on a Metropolitan Municipality area or not;
- whether it is built on an area which is qualified as reserve construction or risky or on a location where risky buildings exist based on Law No 6306 on the Transformation of Areas Under Disaster Risk; and
- the land unit square metre tax value.

VAT, if incurred by non-resident companies, cannot be offset or recovered, and should be considered as part of the cost.

Title deed fee

The acquisition of legal title to Turkish property is subject to 2% title deed charge on the higher of property tax value or the transaction amount. The same charge will apply when the property is sold. This charge is applied separately for buyer and seller. As a result, the total title deed charge over the property that has to be paid would be 4%.

Stamp tax

Stamp tax is calculated over the sales price of the real estate property indicated in the asset purchase agreement (if any) at the rate of 0.948% with a ceiling of 3,239,556.40 TRY (approximately 405,000 EUR at the current exchange rate; subject to annual revaluation) for the year 2020. The original signed copy of an agreement is subject to stamp tax. Furthermore, there are also certain stamp tax exemptions which might be applicable to the real estate sector.

Property tax

Property tax is levied on the owner of real estate at 0.2% on buildings. If the buildings are used for residential purposes, it is reduced to 0.1%. For newly constructed buildings, this tax cannot be lower than the property tax of the land on which it is built. In a few cases, such as retirement homes, the tax rate is 0%. Also, the property tax rate for development land is 0.1%, whereas the rate for arable land is 0.3%.

Furthermore, the effective property tax rates are increased from 0.1% to 0.2% for residences and from 0.2% to 0.4% for other buildings that are located within the borders of metropolitan areas.

Real estate investment companies (REICs)

A Turkish Real Estate Investment Company (REIC) is a capital market institution that can invest in real estate and capital market instruments based on real estate, real estate projects and rights based on real estate. Turkish REICs are corporate income tax-exempt stock companies that must be listed on an organised stock market in Istanbul. Currently, there are 33 REICs listed on the Borsa Istanbul (BIST).

REICs may be established for a limited time to undertake a certain project, for a limited or unlimited time to invest in certain areas or, for a limited or unlimited time without any limitation of purpose. Furthermore, a REIC can be established by immediate establishment, ie, by establishment of a new joint stock company. Moreover, an existing company can be converted into a REIC by amending its articles of association.

At least 25% of the REIC's shares should be offered to the public. REICs are obligated to offer share certificates representing 25% of their capital to the public within three months following the registration of incorporation or amendment of the articles of association with the Trade Registry.

The minimum capital requirement for a REIC is 43.2 million TRY for the year 2020.

Taxation of a REIC

Profits generated from the activities of REIC are exempt from corporate income tax and the dividend withholding tax rate is 0%.

The transactions of REICs are, however, subject to VAT and most other transfer taxes.

Taxation of investors receiving dividends from a REIC

Although dividend distributions to individual and non-resident shareholders of Turkish companies are currently subject to dividend withholding tax at the rate of 15% in Turkey (double tax treaty provisions are reserved), dividend distributions to individual and non-resident shareholders of the REICs have currently no dividend withholding tax burden at all, while the withholding tax rate is determined as 0% for REICs by the Council of Ministers.

Dividends received by resident corporations

Since REICs are exempt from corporate income tax, "participation exemption" is not applicable for the dividends received from REICs. So, dividends received by corporations in Turkey from REICs are subject to CIT at the rate of 22% (for 2018, 2019 and 2020; and for the following years at 20%). In line with local regulations, those distributions are also subject to dividend withholding tax if distributed to non-resident companies or individuals.

Dividends received by non-resident corporations

Taxation of dividends in the hands of a non-resident corporation depends on the tax treatment of the country of residence.

Dividends received by resident individuals

Resident individual shareholders of REICs are obliged to declare half of the dividends received from REICs if half of the dividends received are higher than the declaration limit (40,000 TRY or approximately 5,000 EUR for the year 2020). Declared income will be subject to income tax at the progressive rate between 15% and 40%.

Dividends received by non-resident individuals

Dividends that are distributed by a REIC will be subject to a 0% dividend withholding tax in Turkey. On the other hand, taxation of dividends in the hands of non-resident individuals depends on the tax treatment of the country of residence.

Taxation of capital gains from disposal of REIC shares

Capital gains received by resident corporations

Capital gains derived from the sale of REIC shares by resident legal entities are to be included in the corporate income and will be subject to CIT at 22% (for 2018, 2019 and 2020; and for the following years at 20%). However, there is a special partial exemption method that can be used to minimise tax burden which is available for 75% of the gains derived from the sale of shares that are held for at least two years under certain further conditions.

Capital gains received by non-resident corporations

Since REICs are public companies, capital gains derived from the sale of shares in the Borsa Istanbul by non-resident legal entities that do not have a permanent establishment (PE) in Turkey will be subject to taxation via WHT. The current rate of 0% withholding tax is applicable for capital gains received by non-resident corporations and, that tax will be the final tax for those companies.

Capital gains from the sale of non-listed Turkish company shares by non-resident corporations that do not have a PE in Turkey are to be declared after the application of cost adjustment (adjustment of the original cost by the wholesale price index (WPI), except for the month in which the shares are sold if the total WPI increase is more than 10%), within 15 days following the sale of shares, through a special corporate income tax return and be taxed at the standard CIT rate. Additionally, a dividend WHT will be applied on the net gains. But, since most of the double tax treaties prohibit Turkey's taxation right on these capital gains, depending on the holding period of the Turkish company shares, an examination of the respective double tax treaties should be executed before these transactions are made.

Capital gains received by resident individuals

Since REICs are public companies, capital gains derived from the sale of shares in the Borsa Istanbul by resident individuals will be subject to taxation via WHT. The current rate of 0% WHT is applicable for the capital gains received by resident individuals and that tax will be the final tax for those individuals.

Capital gains received by non-resident individuals

Since REICs are public companies, capital gains derived from the sale of shares in the Borsa Istanbul by non-resident individuals will be subject to taxation via WHT. The current rate of 0% WHT is applicable for the capital gains received by non-resident individuals and that tax will be the final tax for those individuals.

Real estate investment funds (REIFs)

Real Estate Investment Funds (REIFs) have been introduced into Turkish law with the Capital Market Board (CMB) Communiqué on "Principles Regarding Real Estate Investment Funds" ("REIF Communiqué"), which was published in the Official Gazette dated 3 January 2014 (No 28871). This Communiqué aims to provide the regulatory framework for the establishment and operation of Turkish REIFs, the sale of Turkish REIF units to qualified investors (QIs), and related transparency and reporting requirements for REIFs. The Communiqué became effective on 1 July 2014. From that time, it has legally been possible to establish REIFs in Turkey.

Turkish REIFs are contractually formed open-end funds. Turkish REIFs are defined as asset pools (collective investment schemes) with no legal personality, established and managed by Portfolio Management Companies (PMCs) or Real Estate Portfolio Management Companies (REPMCs) that have operating licenses from the CMB, for a definite or indefinite period of time, on behalf of QIs, on the basis of fiduciary ownership, for the purpose of making real estate investments in a wide range of real property assets such as land, real property, residences, offices, shopping malls, hotels, logistical centres, warehouses, parks, and hospitals, or any purpose at all.

REIFs have "legal personality" only for the purposes of land registration, changes related to registration, cancellations and corrections at the Land Registry Office.

PMCs or REPMCs have to be established in joint stock company form. One PMC and/or REPMC may manage several REIFs. A REIF is set up as a specialised fund which is accessible to QIs only.

Any person owning at least 1 million TRY (approximately 125,000 EUR) worth of financial assets including bank reserves and/or capital market instruments, shall be classified as a QI. Also, QI status is granted to intermediary institutions, banks, pension funds, and similar financial institutions. Additionally, Turkey's Central Bank and other state organisations, alongside international institutions, benefit from QI status.

The key characteristic features of REIFs are:

- REIF units can only be sold to QIs;
- the minimum amount of the fund to be raised and invested must be at least 10 million TRY within one year following issuance of units (otherwise the fund must be liquidated);
- REIFs can only be established and managed by Turkish PMCs or REPMCs which require licenses issued by the CMB;

- the founder (founding Turkish PMC or REPMC) may manage the fund, or alternatively, a third party Turkish PMC or REPMC can be assigned as the manager;
- unlike REICs, REIFs do not have legal personality (except for property law purposes) but rather, they are asset pools contractually created with a prospectus;
- REIFs cannot engage in any activity other than real estate investments and other allowed investments (eg, investment fund participation units, repo and reverse repo transactions);
- unlike REICs, REIFs cannot invest in real estate development projects;
- at least 80% of the total value of a REIF should be composed of real estate investments;
- assets of REIFs should be kept by an independent portfolio custodian;
- assets of REIFs must remain separate from the assets of the founder (principal), the custodian, and the manager;
- REIFs are regulated and supervised by the CMB; and
- REIFs are fully exempt from corporate taxation.

Taxation of REIFs

Income earned by a Turkish REIF is fully exempt from CIT. Moreover, REIF income benefitting from CIT exemption is also subject to 0% WHT.

Both, cash dividend receipts (eg, periodic) from REIFs and cash proceeds from returning units to the founder (redemption) by QIs, possess the same characteristics for Turkish tax purposes. Therefore, in our view, income generated by REIF investors by either means, should be treated as “dividend income”.

According to the draft guideline issued by the Revenue Administration, income derived from the disposal of REIFs participation certificates are “capital gains”; and both capital gains and cash dividends fall under the scope of the WHT regime (under the Income Tax Law, temporary Article 67).

The transactions of REIFs are also subject to VAT and most other transfer taxes.

Taxation of investors receiving dividends from a REIF

Distribution from REIFs to QIs will be subject to Turkish taxation as mentioned below.

Dividends received by resident corporations

For resident corporate QIs (including non-resident corporate taxpayers that have a PE, such as a branch office, in Turkey), income from REIFs are subject to withholding taxation at the rate of 0%. Dividends from REIFs received by resident corporate QIs are subject to the CIT rate at 22% (for 2018, 2019 and 2020; and for the following years at 20%). In other words, corporate QIs cannot benefit from the participation exemption with respect to their investment incomes from Turkish REIFs.

In line with local regulations, those distributions are also subject to dividend WHT if distributed to non-resident companies or individuals.

Dividends received by non-resident corporations

For non-resident corporate QIs, 0% withholding tax on distributions from REIFs is the final taxation, and the non-resident corporate QIs are not required to make any filing.

On the other hand, taxation of dividends in the hands of non-resident corporations depends on the tax treatment of the country of residence.

Dividends received by resident individuals

Distributions from REIFs to resident individual QIs are subject to 10% WHT. This 10% WHT is the final Turkish tax burden.

Dividends received by non-resident individuals

Non-resident individual QIs participating in REIF(s) are not required to make any tax filing. The 10% WHT is the ultimate Turkish tax burden.

On the other hand, taxation of dividends in the hands of non-resident individuals depends on the tax treatment of the country of residence.

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Real Estate Going Global

Ukraine

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 31 July 2020.

Real Estate Tax Summary

Legal considerations

A foreign investor may purchase Ukrainian property either directly or through a local company. However, there is a requirement for foreign individuals who rent out premises in Ukraine to do so via a Ukrainian legal entity or a private entrepreneur acting as their agents.

Foreign individuals and companies may acquire only a non-agricultural land plot, which is attached to the real estate object. Non-residents may lease land for up to 50 years. Ukrainian companies with 100% foreign ownership may not purchase land in Ukraine.

Taxation of rental income

Profits earned from renting out real estate by a resident company or via a non-resident's permanent establishment are taxable in Ukraine at the standard corporate income tax (CIT) rate of 18%.

Rental income received by a non-resident company from Ukraine is subject to 15% Ukrainian withholding tax (WHT).

Individuals' income (both resident and non-resident) from renting out property is taxed at the standard 18% personal income tax (PIT) rate plus 1.5% military tax (effective until the reformation of the Ukrainian Military Forces is completed).

The lease of privately owned buildings, premises and land is subject to 20% value-added tax (VAT). The lease of state-owned land and premises (as integral property complex) of state-owned enterprises is exempt from VAT, if the lease payments are paid to state or local budgets.

Sale of property

Capital gains from the sale of property by a resident or a non-resident's permanent establishment are subject to CIT at the standard rate of 18%.

Under Ukrainian domestic law, income realised by a non-resident company from the sale of real estate located in Ukraine is subject to 15% withholding tax, unless otherwise is provided by relevant double tax treaty.

Ukrainian individuals' income from the sale of real estate (including incomplete constructions) is subject to personal income tax at 5% (plus 1.5% military tax), which can be reduced to 0% in certain cases. Income of non-resident individuals is subject to 18% PIT plus 1.5% military tax.

The transfer of real estate is also subject to a stamp duty at the rate of 1% of the contract value. The duty is payable by either the seller or the buyer, depending on the agreement between the parties to the transaction.

A special charge to the State Pension Fund of 1% applies to the purchase of real estate (except for land plots) by individuals and companies.

The supply of buildings or premises is subject to 20% VAT. VAT exemption applies to second and subsequent supplies of housing.

The supply of land is exempt from VAT, except where the value of the land is included in the value of the real estate according to Ukrainian legislation.

Thin capitalisation rules

The effective Ukrainian thin capitalisation rules apply to companies whose debts to non-resident related parties exceed equity by 3.5 times (10 times for financial institutions and leasing companies). The deduction of interest expense on loans from non-resident related parties for these taxpayers is limited to 50% of EBITDA. The non-deductible portion of interest can be carried forward indefinitely. However, each following year the residual amount of such not deducted interest should be reduced by 5%. For the purposes of thin capitalisation rules, debt includes any loan, deposit, repo transactions, financial leasing, and any other indebtedness, regardless of its legal form.

Starting from 1 January 2021, some changes will be introduced to thin capitalisation rules in Ukraine. For more information, please see the section "*Thin capitalisation*" below.

Beneficial ownership

The Ukrainian Tax Code prescribes that the "beneficial ownership" and principle purpose tests need to be satisfied in order to claim an exemption or reduced WHT rate under the relevant double tax treaty (if the respective test is also envisaged by the respective treaty).

Starting from late May 2020, Ukrainian tax legislation provides for a look-through approach, ie, if the direct recipient of Ukrainian-sourced income is not the beneficial owner, the reduced rate under the double tax treaty with the jurisdiction of the beneficial owner may be applied.

Real Estate Investments

General

Ownership of a property is a right to possess, enjoy, use and dispose the property within the limits provided under the law.

Unlike in some other jurisdictions, in Ukraine the ownership of land and building may be split.

In general, the ownership of real estate is governed by Ukraine Civil Code, Ukraine Land Code, Ukraine Commercial Code, Law of Ukraine on the State Registry of Property Rights, etc.

Ownership rights to real estate are subject to state registration. The long-term (more than three years) lease of real estate, other than land, is subject to notarisation and state registration.

The legal effect of land transfer (ownership, lease) occurs only after such transfer and state registration.

Real estate (other than land) ownership

Under Ukrainian law, no special permits or licences are generally required for a foreign investor to purchase buildings (premises) located in Ukraine.

Special procedures, however, can be applied to certain categories of real estate (ie, cultural heritage objects, integral property complexes, etc).

Property rights to real estate and their encumbrances are subject to state registration.

A foreign corporate or individual investor may acquire real estate either directly or via a local company.

Real estate (land) ownership

Non-agricultural land ownership

Effective as of 1 January 2002, foreign individuals and companies may acquire only non-agricultural land within the territory of settlements or outside the territory of settlements where the land is attached to real estate.

Non-residents can lease the land for up to 50 years.

Ukrainian companies with 100% foreign ownership may not purchase land in Ukraine.

Generally, a foreign legal entity may purchase state non-agricultural land subject to a resolution of the Cabinet of Ministers of Ukraine and consent of the Ukrainian Parliament. A foreign legal entity may also purchase municipal non-agricultural land from a relevant municipal council, subject to the consent of the Cabinet of Ministers of Ukraine. To purchase state or municipal non-agricultural land, the foreign entity must set up a commercial representative office in Ukraine.

As a general rule, state and municipal non-agricultural land should be sold or leased via a public land auction. There are certain exceptions to the mandatory land auction rule: the acquisition of land plots under objects of immovable property owned by companies and individuals, as well as the acquisition of land plots for the construction and maintenance of transport and energy infrastructure (eg, roads, airports), the construction of social housing, objects that serve the municipality (eg, waste processing plants, heating stations, etc), the comprehensive reconstruction of old residential districts and some other cases.

These restrictions apply to foreign individuals and foreign companies.

Agricultural land ownership

According to the Ukrainian law in effect, foreigners (foreign citizens, stateless persons, foreign companies, or foreign states), as well as joint ventures may not own agricultural land in Ukraine.

Currently in Ukraine there is a “land moratorium” on the alienation of agricultural land.

However, according to the Law of Ukraine “On making amendments to some legislative acts of Ukraine concerning the market of agricultural land” the land market will open on 1 July 2021.

The key points of this law, inter alia, are as follows:

- Ukrainian citizens can purchase land plots of no more than 100 hectares starting from 1 July 2021.
- Legal entities can purchase land plots of no more than 10,000 hectares starting from 1 January 2024.
- Ukrainian legal entities with foreign owners will get the right to purchase land plots in Ukraine if the relevant decision is adopted by a nationwide referendum.
- Banks can purchase agricultural land plots only in case of a foreclosure on them as collateral.
- Such land plots must be sold by banks in public bids within two years.
- The sale of state and municipal lands is prohibited.
- Payment for the acquisition of land can be made only in non-cash form.

Although the new law contains some restrictions on the full opening of the agricultural land market to all parties, the parliament's decision is a very positive signal and a decisive first step toward comprehensive land reform in Ukraine.

Leasing out of real estate

According to the provisions of the Ukrainian tax legislation, a foreign individual should appoint a Ukrainian legal entity or a private entrepreneur to act as its tax agent in order to be able to lease out real estate.

The Ukrainian tax legislation does not contain similar restrictions for foreign corporate investors, but in some clarification letters the tax authorities expressed the view that non-resident entities may lease out the real property only through their permanent establishment or an authorised property manager.

Taking real estate on lease

There are no restrictions for foreigners (both individuals and companies) to take buildings (structures) on lease.

Non-residents can lease land for up to 50 years.

Taxation of rental income

Where the foreign corporate owner of real estate receives rental income from a Ukrainian resident or a non-resident permanent establishment (PE), the lessee is obliged to withhold from the rental fee and remit to the state 15% WHT, unless the relevant double tax treaty provides otherwise.

If a PE is deemed to exist, then it is subject to broadly the same taxation regime as a Ukrainian-resident entity.

Profits earned from renting out real estate by a resident company or via a non-resident's PE are taxable at the standard CIT rate of 18%.

Deductible expenses

The Tax Code determines taxable profits as net profits before tax (NPBT) as per accounting records, either Ukrainian statutory or IFRS, and adjusted for "tax differences". Some of these "tax differences" make certain expenses non-deductible or partially deductible (eg, interest falling under the thin capitalisation rule, depreciation of goodwill and fixed assets not engaged in business activity, payments to the residents of "low-tax" jurisdictions, etc).

Taxpayers whose prior year annual income equals to or less than 40 million Ukrainian hryvnias (UAH), approx. 1,400,000 USD, may opt out of making the adjustments, ie, all their expenses remain deductible.

Interest

Generally, interest is a deductible expense under accounting rules, either Ukrainian statutory or IFRS. However, in certain cases, interest deductibility may be limited due to thin capitalisation rules (see section "*Thin capitalisation*" below).

Interest expenses on loans incurred by a Ukrainian company for the purposes of creation of qualifying assets in accordance with the Ukrainian accounting standards will not be directly deductible, but rather capitalised for subsequent depreciation.

Withholding tax on interest payable by a domestic borrower to a non-resident creditor is levied at the rate of 15%, unless the relevant double tax treaty provides otherwise.

The Ukrainian Tax Code prescribes the “beneficial ownership” test that needs to be satisfied in order to claim the exemption/reduced WHT rate based on the relevant double tax treaty. In addition, Ukrainian tax legislation provides for a look-through approach, ie, if the direct recipient of Ukrainian-sourced income is not the beneficial owner, the reduced rate under the double tax treaty with the jurisdiction of the beneficial owner may be applied. For such purposes. the actual beneficial owner should submit a specific claim to the tax authorities and provide the documents supporting its beneficial owner status. Therefore, back-to-back and similar financing structures need to be thoroughly structured in order to ensure their tax-efficiency.

Thin capitalisation

Ukrainian thin capitalisation rules apply to companies whose debts to non-resident related parties exceed equity by 3.5 times (10 times for financial institutions and leasing companies). The deduction of interest expense on loans from non-resident related parties for these taxpayers is limited to 50% of EBITDA. The non-deductible portion of interest can be carried forward indefinitely. However, each following year the residual amount of such not deducted interest should be reduced by 5%. For the purposes of thin capitalisation rules, debt includes any loan, deposit, repo transactions, financial leasing, and any other indebtedness, regardless of its legal form.

Starting from 1 January 2021, the following changes will be introduced to thin capitalisation rules:

- Rules will apply to legal entities whose debts to all non-residents (not only related parties) exceed equity by 3.5 times.
- The deduction of interest expense under transactions with all counterparties (including residents) for these taxpayers will be limited by the amount of 30% of the corporate income tax base (excluding tax losses carried-forward from previous periods) increased for the amount of financial expenses under accounting rules and tax depreciation.
- The limitation will also apply to the part of the depreciation of the qualifying asset capitalised in the prior periods.
- The limitation will apply only to the amount of interest that corresponds with the arm’s length principle.
- The "thin capitalisation” rules will no longer apply to financial institutions and companies engaged exclusively in leasing activities.

Depreciation

According to the Tax Code, tax depreciation rules are aligned to financial accounting rules with some modifications.

All non-current assets are classified into 16 classes of fixed assets, including separate sub-classes for land, buildings and constructions. Taxpayers are allowed to choose a depreciation method per class of assets. There are five depreciation methods available: straight-line, accelerated reduction of a residual value, cumulative, reducing balance and production-based. The Tax Code sets a minimum period for the useful life per class of assets for tax purposes.

The indicative annual depreciation rate for buildings under the straight-line method is up to 5% and under the reducing balance method is up to 16%. The value of land is normally not subject to depreciation.

Loss carry forward

Ukrainian tax legislation provides for tax losses to be carried forward indefinitely with no limitations.

Withholding tax on dividends

The payment of dividends to non-resident shareholders is subject to a WHT at the rate of 15%, unless the relevant double tax treaty provides otherwise.

Value-added tax (VAT)

The supply of buildings or premises is subject to 20% VAT. A VAT exemption applies to second and subsequent supplies of housing.

The supply of land is exempt from VAT except where the value of the land is included in the value of the real estate according to Ukrainian legislation.

The lease of privately owned buildings, premises and land is subject to 20% VAT. The lease of state-owned land and premises (as integral property complex) of state-owned enterprises is exempt from VAT, if the lease payments are paid to state or local budgets.

Capital gains on the sale of property

Income from the sale of property (including buildings and land plots) should be recognised according to financial accounting rules, either Ukrainian statutory or IFRS, and taxed at the standard CIT rate of 18%.

Under Ukrainian domestic law, income realised by a non-resident company from the sale of real estate located in Ukraine is subject to 15% WHT. Some double tax treaties concluded by Ukraine limit Ukraine's taxing rights to capital gains in such transactions.

The sale of shares of a Ukrainian entity owning the real estate is subject to 15% WHT and most of the double tax treaties do not provide any exemption from WHT for such a case. The WHT is applicable if:

- the shares of a foreign company, at any time in the 365 days preceding the alienation of shares, derive more than 50% of their value from shares in a Ukrainian company, which is owned directly or indirectly by such a foreign company; and
- the shares of a Ukrainian company, at any time in the 365 days preceding the alienation of shares, derive more than 50% of their value from immovable property, which is owned or used by a Ukrainian company under the long-term lease, financial lease, etc.

Nowadays, the above-mentioned rule applies only to the indirect sale of shares in a Ukrainian entity owning a significant amount of real estate, however there is a draft law passed by the Ukrainian parliament pending the President's signature, which provides the same rules to the direct sale.

In case the buyer is a non-resident of Ukraine, prior to the contemplated transaction, the buyer should register with the Ukrainian tax authorities and pay the WHT due on capital gains.

Please note that if there is no significant immovable property in Ukraine, the transaction should be WHT neutral for both direct and indirect sales.

Personal income tax (PIT)

The income received from the disposal of a house, a flat, a cottage (including attached land), or a plot of land within the limits set by Ukraine's Land Code, if it is the first disposal for a year and the asset was in the individual's possession for more than three years, is non-taxable for both Ukrainian tax residents and (arguably) tax non-residents. Income received from the second and consecutive sales of the above objects, or any sale of a different asset is taxed at 5% PIT plus 1.5% military tax for Ukrainian tax residents and at 18% PIT plus 1.5% military tax for Ukrainian tax non-residents. The above tax rates apply only to property located in Ukraine.

The income received by Ukrainian tax residents from sales of immovable property located abroad is subject to a standard 18% rate plus 1.5% military tax.

The tax should be paid prior to the notarisation of the sale agreement.

For personal income tax purposes, income from disposal of immovable property cannot be lower than the "valuation price" determined by the valuator authorised to perform valuation of property according to the law and registered in a special database. The valuation certificate must be provided to the notary.

Rental income received by an individual is subject to PIT at the standard 18% tax rate plus 1.5% military tax. The taxable income is determined, based on contractual fee, but should not be lower than the minimum rental fee determined according to the methodology established by the Cabinet of Ministers of Ukraine. It is not allowed to deduct any expenses from gross rental income according to the Ukrainian tax legislation.

A business entity that rents real estate from an individual is obliged to withhold 18% PIT and 1.5% military tax from rent payments unless an individual is registered as a private entrepreneur acting in a corresponding capacity.

Tax non-resident individuals are allowed to rent out their property located in Ukraine only through Ukrainian tax agents, either companies or private entrepreneurs.

Real estate transfer tax (RETT)

The transfer of real estate is subject to stamp duty at the rate of 1% of the contract value. The duty is payable by either the seller or the buyer, depending on the agreement between the parties to the transaction.

For the buyer, whether a corporate entity or individual, the purchase of real estate (except for land plots) is subject to a State Pension Fund charge at the rate of 1% of the real estate value.

The Civil Code requires the mandatory notarisation of contracts for the lease of buildings/premises for a period longer than three years. The stamp duty is 0.01% of the contract value, but no more than approximately 35 USD.

The contract for the lease of land may be notarised, which is subject to stamp duty at the rate of 0.01% of the land value determined under the guidelines established by the Cabinet of Ministers of Ukraine. In the absence of the land valuation, the stamp duty is 1% of the contract value.

The sale of shares in a Ukrainian company is not subject to stamp duty or any other transfer taxes.

Land payments

The land tax is paid by either owners or lessees of land plots. In case of lessees, the land payment is levied in the form of rental payments for land use and land tax.

The payment base for land payments is the normative monetary valuation of the land plot adjusted by an indexation rate. If there is no normative valuation of the land plot the taxpayer should apply the normative valuation of the square meter of land in the respective region.

The rate of land payment for landowners is set by local councils and it may vary from 0.3% to 12%. The tax (rent) rate for the land lessee is set in the respective lease agreement, but it may not be less than the land tax rate set by the local councils for land owners in this region and it may not exceed the respective limit set by the Tax Code (depends on the category of land, but the highest is 12%). If the lessee is selected on competitive grounds, the tax (rent) rate may exceed 12%.

Legal entities (both landowners and lessees) have to calculate the land payment due themselves and submit relevant tax returns annually or monthly. The land payment is payable monthly.

Real estate tax (RET)

Owners of residential and non-residential property in Ukraine (both individuals and companies, including non-residents) are subject to local real estate tax (RET), if it is introduced by the local council on the respective territory. The tax base is determined based on the total area of the real estate asset.

Some types of property are exempt from RET, for example:

- industrial buildings (ie, production buildings, workshops, storehouses of industrial entities);
- buildings and facilities of agricultural producers, which are intended for use in agricultural activity; and
- property owned by schools, religious organisations, state authorities and the non-profit organisations established by them, etc.

The RET rate is set by the local council, but generally cannot exceed 1.5% of the minimal salary per square metre. For 2020, the maximum is 70.85 UAH per square metre (approximately 2.5 USD per square metre).

RET paid by legal entities is a tax-deductible expense for CIT purposes.

Individuals may profit from partial RET exemption for residential property, whereby the first 60 square metres for flats or 120 square metres for housing are not subject to RET. Local governments may provide additional exemptions.

If the taxpayer owns one or more residential property objects with a total area of an asset more than 300sqm (for an apartment) or 500sqm (for a house), the tax amount increases by 25,000 UAH (approximately 940 USD) per year for each such asset.

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Real Estate Going Global

United Kingdom

Tax and legal aspects of real estate investments around the globe

2020

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All information used in this content, unless otherwise stated, is up to date as of 10 September 2020.

Real Estate Investments

Preface

In recent years, property investors and developers have become much more international in their outlook. Property has effectively become part of the global marketplace. However, the tax and legal systems that apply to property transactions differ with every jurisdiction, and players in this market need to understand the local implications of their proposed transactions. Otherwise, what looks like a great opportunity on a pre-tax basis may turn out to be a post-tax disaster.

This guide has been prepared to introduce the tax and legal regimes in the United Kingdom (UK) that apply to real estate investors. After a general overview for UK and overseas investors, the guide covers the direct tax aspects of disposals and developments, value-added tax (VAT), transfer duties and other real estate taxes. A legal summary and glossary of legal terms are included in this guide and reference is also made from time to time to relevant legal issues throughout the guide.

The UK is divided for the purpose of pure real estate law, as opposed to tax law, into a number of jurisdictions, the most important being England and Wales together (the largest), Scotland and Northern Ireland. Although the legal systems of these jurisdictions have much in common, they do have substantial differences in the formalities required for the transfer of real estate and some aspects of their substantive law. It is therefore important when dealing with real estate assets in the UK to ensure that legal assistance is provided by someone qualified to advise in the relevant jurisdiction. The remainder of this guide, insofar as it comments on any legal aspects of real estate investment, is concerned with the position specifically in England and Wales, although many of the comments will also apply to the other jurisdictions.

There are also certain tax differences between the jurisdictions. The land and buildings transaction tax (LBTT) replaced the UK stamp duty land tax (SDLT) in Scotland from 1 April 2015, and the land transaction tax (LTT) replaced the UK SDLT in Wales from 1 April 2018. In addition, Scotland introduced its own rates of income tax in April 2017.

Introduction

There have been a number of changes affecting the taxation of real estate in recent years.

From April 2020, income that non-resident companies receive from UK property has been chargeable to corporation tax (rather than income tax). This means that inter alia the restrictions on interest relief and the carry forward of losses will apply to non-resident corporate landlords.

Capital gains on non-resident disposals of UK property were brought within the scope of UK tax from 6 April 2019. This applies to gains on direct and certain indirect disposals. Disposals by companies (including entities which are deemed to be companies) are subject to corporation tax. In other cases, capital gains tax (CGT) will apply.

Following earlier changes restricting the amount of current year profits, for corporation tax purposes, that may be offset by losses from earlier periods, from 1 April 2020, UK and non-resident companies (which are now within the charge to corporation tax) may only offset capital gains with capital losses of earlier period up to 50% of the current year gains. As part of the broader loss restriction rules applying to other types of losses, the first 5 million pounds sterling (GBP) of losses is not restricted.

In respect of SDLT (applicable in England and Northern Ireland), the top rate applying to acquisitions of commercial property increased from 4% to 5% with effect from 1 April 2016. A 3% supplement to the residential SDLT rates was also introduced from 1 April 2016 for corporate and other “non-natural person” (NNP) purchasers, and individuals who are not replacing a main residence. A temporary holiday from SDLT on the first 500,000 GBP of the acquisition of a main home is in place from 8 July 2020 to 31 March 2021. In cases where the acquisition is not of a main home, there still may be a reduction in the total amount of SDLT payable in this period, but the 3% supplement will still apply.

In addition, a 2% SDLT surcharge on non-residents (and certain UK residents) purchasing residential property in England and Northern Ireland will be introduced from 1 April 2021.

Corporate investment in real estate directly by non-resident investors

UK tax on rental income

A company that is not resident in the UK for tax purposes, and not carrying on a trade in the UK through a permanent establishment (PE), was, until 6 April 2020, subject to the basic rate of UK income tax at 20% on UK property business profits.

Since 6 April 2020, however, non-resident companies have been brought within the charge to corporation tax (currently at 19%) on UK property business profits although withholding at the basic rate of income tax may still apply. As profits of a UK property business (for corporation tax purposes) do not take into account debits or credits from loan relationships or derivative contacts, a non-resident company which carries on a UK property business will also be chargeable to corporation tax in respect of its debits or credits that arise from loan relationships or derivative contracts that the company is a party to for the purpose of that business.

Non-residents which are not companies will continue to be subject to income tax on UK property business profits. Withholding tax (at the rate of 20%) is deducted on payments of rent to all non-residents unless they are registered to receive rents gross.

In 2020/2021 certain non-resident individuals may have a personal allowance of 12,500 GBP and are then subject to basic rate income tax at 20% on net taxable income up to 50,000 GBP, and then to higher rate income tax at 40% on net income falling between the limits of 50,000 GBP to 150,000 GBP. An additional rate of 45% applies on net taxable income in excess of 150,000 GBP.

A special rate of income tax of 45% is applicable to certain non-resident trusts, where income is accumulated or is payable at the discretion of the trustees. The taxation of trusts is a specialist area and is not covered in this guide.

Ownership of real estate

There are no significant legal differences in the way that companies and individuals, UK resident or otherwise, may hold real estate in the UK. However, no more than four persons, whether individuals or companies, may be registered as owners of real estate at the Land Registry (except where the land is vested in trustees for charitable, ecclesiastical or public purposes where there is no limit on the number of trustees).

Real estate law recognises two distinct kinds of ownership. “Legal ownership” concerns the party that can prove legal title to the property (the proprietor named on the deeds), whereas “beneficial ownership” is the entitlement to the economic benefit of a property (for example under a trust or similar arrangement).

Real estate can be owned either absolutely and for an unlimited duration, as freehold, or may be rented from another person under a lease for a specified period, as leasehold. There are no limits on the length of a lease, but the length chosen may have other consequences. Both a freehold and a leasehold owner may create leases of their property provided that, in the case of a leasehold owner, the terms of the owner’s own lease permits such dealings, and that the new lease created, as sublease, is shorter than the owner’s own lease. For more detail, see section “*Legal summary and glossary of terms*”.

Basis of assessment

Rent under commercial leases in the UK is normally paid in quarterly instalments on 25 March, 24 June, 29 September and 25 December, known as the traditional quarter days. Sometimes the modern quarter days of 1 January, 1 April, 1 July and 1 October are used instead. In residential leases, or leases of serviced accommodation, rent is normally paid monthly or weekly.

Rent payments are most frequently made in advance of the period to which they relate.

The taxable profits of a property business are however determined, for both income and corporation tax purposes, in accordance with commercial accounting principles. All rental income is aggregated and taxed on an accrual basis. Expenditure is deductible on the same basis as expenditures relating to a trade (see section “*Allowable expenses*”). However, in relation to loan relationships and derivative contracts, different rules apply for corporation tax purposes.

For corporation tax purposes (so for non-resident companies from 6 April 2020), the period of assessment under corporation tax will be the same as the company’s accounting period, so long as this period does not exceed 12 months. If the accounting period exceeds 12 months, then it will be split, for tax purposes, into two separate periods, with the first period consisting of the first 12 months of the accounting period, and the second period consisting of the remainder of the accounting period. For accounting periods straddling 6 April 2020, the first period

of assessment for corporation tax will commence on 6 April 2020. For income tax purposes, the period of assessment is the tax year that runs from 6 April of one year to 5 April of the following year.

Where tax has not been deducted at source from rental receipts (see section "*Withholding tax*") or the tax deducted is insufficient, corporation tax will be payable by company non-resident landlords. The corporation tax liability for the first accounting period of non-resident corporate landlords after they have come within the corporation tax regime will be due nine months and one day after the end of the accounting period. For subsequent periods, tax payment dates will depend on the size of the company (by profitability) – see section "*Investment in real estate via a local company/Corporation tax self-assessment (CTSA)/Quarterly payments*").

Similarly, non-resident landlords which are not companies, where tax has not been deducted at source from rental receipts, or the tax deducted is insufficient, will be required to make two payments on account of any additional income tax based on the previous year's tax liability. The first instalment is payable by 31st January during the year of assessment, and the second instalment is payable by 31st July following the year of assessment. Any balance is payable by 31st January following the year of assessment.

Withholding tax

As noted above, rents are subject to withholding tax. However, where a non-resident landlord applies to UK's HM Revenue & Customs (HMRC) to receive rents gross, and that application is successful, the landlord will become subject to UK tax under the self-assessment regime. By so applying, the landlord will undertake to comply with UK tax law and submit tax returns in accordance with that law. In return, the non-resident landlord will be entitled to receive rental income gross. If no application is made by the non-resident landlord, or where an application is made but rejected, tax will be withheld at source from rents paid to the landlord. Where the tenant pays rent directly to the non-resident landlord, the tenant will deduct basic rate income tax at 20% from the gross rent payable, less any deductible expenses paid by the tenant. Where rental income is paid via a registered agent, the agent will similarly deduct basic rate income tax from the gross rent payable, less any deductible expenses paid by the agent. In both instances the payer, whether a tenant or registered agent, must be reasonably satisfied that the expenses paid are deductible under the tax laws (see section "*Allowable expenses*"), and no relief can be given for expenses, for example interest, paid directly by the landlord.

Non-resident company landlords are subject to the corporation tax interest restriction rules from 6 April 2020, and special rules also apply to those non-resident company landlords that have an amount withheld on account of tax from their rents under the non-resident landlord (NRL) scheme. These rules are complex and being "reasonably satisfied" that financing costs would be deductible may require a letting agent to obtain information about the non-resident company landlord and its funding arrangements. In practice, whilst some letting agents would be able to apply these rules others may not. In the latter case the existing regulations would typically prevent a deduction for financing costs paid by the letting agent, which would increase the amount to be withheld on account of tax. In such cases the non-resident company landlord would need to file a company tax return to directly claim a deduction for its financing costs and claim a refund of tax, thus increasing the administrative burden on both HMRC and non-resident company landlords.

To avoid this, a simpler alternative to the corporate interest restriction is provided to broadly enable the agent to elect to calculate the financing cost deduction which is limited to a fixed allowance (30%) of the UK rental income, net of deductible expenses other than financing costs.

Where an agent or tenant withholds income tax, this must be accounted for and paid to HMRC on a quarterly basis. The agent or tenant must then provide the non-resident landlord with a certificate showing gross income, expenses paid, and tax deducted from that income. An annual return must also be submitted by the agent or tenant to HMRC disclosing the following details:

- the landlord;
- gross income derived from the properties;
- expenses paid by the agent or tenant out of that income; and
- the resulting net income and income tax deducted during the period.

Any tax deducted at source is used to offset the landlord's UK tax liability, and any excess will be repaid by HMRC once that liability has been agreed upon.

Requirements to file a tax return

A non-resident landlord is not obliged to file an income tax or corporation return (as appropriate) where the agent or tenant has withheld sufficient income tax from the rents to meet the landlord's UK tax obligations. However, as noted above, a non-resident landlord can elect to receive rents gross and will then be required to file a UK tax

return, and it will usually be to the landlord's benefit to do so in order to receive rental income gross and claim relief on all relevant expenditure.

A non-resident company landlord which was previously liable to income tax should automatically receive notifications to file a corporation tax return, and a non-resident company landlord which was not previously within the scope of income tax is required to notify its chargeability to corporation tax within three months.

However, as noted above, the non-resident company landlord is not required to file a corporation tax return where its liability to corporation tax has been fully met by income tax deducted on rental receipts. As noted above, the taxable profits are calculated by reference to the accounting profits and therefore the tax withheld will not necessarily be the same as the tax liability.

A corporation tax return needs to be completed and filed online, usually within 12 months of the period of assessment (see section "*Investment in real estate via a local company/Period of assessment*").

A non-resident individual whose income tax liability has not been fully met by income tax deducted on rental receipts, eg, because they have been paid gross, or because they are chargeable to UK income tax at the higher rate, is required to notify HMRC within six months of the end of the year of assessment in which the chargeable income arises. Also, a non-resident individual can only claim deductions in addition to those paid by the agent, or tenant, as described in the section "*Withholding tax*" above, against the rental income if the individual submits an income tax return to HMRC. In this case, the individual will be assessed at the higher rate of 40% or the additional rate of 45% on the appropriate proportion of their net income. The income tax return covers the year to 5 April and is due for filing via paper submission by the following 31 January.

Allowable expenses

Most expenses incurred in the rental business, other than those of a capital nature, are deductible, provided they are incurred wholly and exclusively for the purposes of the UK rental business. These will include items such as agent's fees, insurance, advertising, repair and maintenance costs, and will be shown as deductions when computing profits in the annual tax return where this is submitted.

Some of these expenses may be recoverable by a landlord from its tenants through a service charge. The extent to which this is possible will depend on the service charge provisions that the landlord and the tenant have negotiated and agreed upon. While tenants will generally accept that they must reimburse the landlord's costs of insurance and repair, they are unlikely to agree to pay advertising fees. Management costs may be recovered, although often only limited amounts.

Financing costs

The rules applying to non-resident company landlords for corporation tax purposes are broadly the same as those applying to UK companies, with certain exceptions. Under the UK corporation tax regime, financing costs are in principle deductible on an accruals basis, subject to certain restrictions (see section "*Investment in real estate via a local company/Financing costs*" below).

Whereas UK companies can obtain a deduction for the costs relating to all of their loan relationships and derivative contracts, the deductions available to a non-resident company are limited to the loan relationship and derivative contract costs relating to the UK property business.

There is also an additional restriction for non-resident companies in respect of financing costs incurred during the development of an investment property. Unlike a UK tax resident company which may claim interest deductions (eg, during the development of an investment property) as a non-trade debit prior to the commencement of its property business, a non-resident company which is not otherwise within the charge to corporation tax only gets relief for such debits when it commences its property business.

Under the UK income tax regime, financing costs are in principle deductible on an accruals basis where the interest is paid wholly and exclusively for the purposes of the UK rental business. However, there are a number of potential restrictions.

Under transfer pricing legislation, a limitation will apply eg where interest is paid to, or is guaranteed by, a connected party. In those circumstances, relief for interest will, broadly speaking, be limited to an amount equal to the interest that would be payable on the largest loan that could have been obtained from an unconnected lender without a guarantee. The transfer pricing provisions also apply to cases where a number of otherwise unconnected persons act together in relation to the financing of a company, and collectively these persons would be capable of controlling the company.

In addition, over the four years from April 2017, tax relief for financing costs incurred by non-resident residential landlords who are individuals subject to higher and additional rates of income tax has been phased out as follows:

- For 2017-18, the deductible amount in respect of the finance costs is 75% of the amount which would have previously been allowed.
- Reducing to 50% for 2018-19, 25% for 2019-20, and for 2020-21, there is no deduction allowed in respect of the finance costs.

Instead, income taxpayers will be allowed to claim a basic rate tax reduction (currently 20%) from their income tax liability on the portion of finance costs not deducted in calculating the profit as above.

Where loan interest is paid to a non-resident, 20% withholding tax should be deducted by the payer if the loan has a UK source, unless advantage can be taken of a double tax treaty (DTT) to reduce or eliminate the withholding tax. HMRC guidance states that whether interest paid by a non-resident borrower will have a UK source will be determined by an number of factors, being the residence of the debtor, the location of its assets, the place of performance of the loan contract, the method of payment, the competent jurisdiction for legal action and the proper law of the contract, the residence of any guarantor, and the location of the security for the debt. Where the borrowings are from non-resident-related parties, and exemption is claimed under a treaty, some of the interest may be excluded from treaty protection under thin capitalisation provisions.

Depreciation (capital allowances)

Depreciation is not generally deductible. However, capital allowances can be deducted as an expense of the rental business in relation to qualifying expenditure on certain types of buildings, and on plant and machinery in buildings, at the following rates:

- 18% allowance a year, using the reducing balance method, on plant and machinery in industrial or commercial buildings;
- 6% allowance a year, using the reducing balance method, on plant and machinery that has an expected economic life when new of at least 25 years (8% pre-April 2019);
- 6% allowance a year, using the reducing balance method, for certain listed plant and machinery that are “integral features” of buildings and structures, comprising heating and hot water systems, ventilation and air conditioning, electrical systems (including lighting), cold water systems, lifts, escalators and moving walkways, and external solar shading (8% pre-April 2019);
- A 100% first year allowance (FYA) is available on certain eligible expenditure incurred by 31 December 2020, including environmentally beneficial plant and machinery, and designated energy-saving technology and products. An annual investment allowance (AIA) provides individuals, certain partnerships and companies with an annual 100% allowance for the first 1 million GBP of expenditure between 1 January 2019 and 31 December 2020 on plant and machinery (other than cars). One such allowance is available to each individual business or corporate group.
- A 100% FYA for plant and machinery expenditure incurred by companies on or before 31 March 2021 in respect of a trade (ie, not property investors) in a limited number of designated Enterprise Zones.
- A 3% per annum structures and buildings allowance (SBA), on a straight-line basis (2% between 29 October 2018 and 1 April 2020 (for corporation tax) and 6 April 2020 (for income tax) in respect of qualifying expenditure on eligible structures and buildings (which are not dwellings)). Expenditure on which the SBA has been claimed is excluded when calculating capital gains.

The rates of allowance and basis of calculation will usually be different for expenditures on second-hand buildings. Where available, these allowances will be deducted from the net income of the rental business.

Contaminated land remediation relief is also available to companies subject to corporation tax (both UK resident and non-resident) incurring qualifying expenditure. Provided the relevant conditions are satisfied, the legislation entitles a company carrying on a trade or property business to claim an additional 50% relief for “qualifying land remediation expenditure” allowed as a deduction in computing its profits.

Capital allowances are not available for expenditures on fixtures in dwelling houses, although historically a wear and tear allowance of up to 10% of rental receipts from furnished lettings has been available for fully furnished properties.

Since April 2016, the wear and tear allowance has been replaced by relief for the actual cost of replacement furnishings. The new rules provide for relief for the actual cost of replacing furniture, furnishings, appliances and kitchenware provided for the tenant’s use. The relief covers the cost of replacement and not the initial cost of the original item and applies to unfurnished and part furnished (in addition to fully furnished) residential properties.

Special rules on fixtures acquired second-hand require a buyer and seller to enter into elections in order for allowances to pass to the buyer. Since April 2014, in certain cases a buyer has not been able to claim allowances if the seller has not “pooled” the expenditure.

In order to ensure that the capital allowances position is as favourable to an investor as possible, it is advisable to include provisions about capital allowances in the documentation effecting the sale, purchase or lease of the real estate concerned.

Under certain long funding leases, a complex definition that includes both finance leases and operational leases, the inherent capital allowances entitlement belongs to the lessee, as opposed to the lessor, in respect of leased plant or machinery. However, in the case of property such as offices and retail premises which include items of background plant or machinery, such as central heating and air conditioning, the legislation will not normally apply where this plant or machinery is leased as an incidental part of a typical property lease.

In addition, in the case of some properties, there might be a small amount of plant or machinery that does not fall within the background plant or machinery exemption but is nevertheless exempted under certain de minimis conditions.

Losses

Where an investor which is not a company, within the charge to UK income tax on rental income, incurs a loss on the rental business after deducting interest and capital allowances, the loss will be available to be carried forward and applied against future profits of the rental business without time limit.

Where a company investor within the charge to corporation tax on rental income (from 6 April 2020) incurs a loss on the rental profit business, the losses may be used to offset other profits of the company within the charge to UK corporation tax (if any). Any excess may be used to offset other group companies' profits within the charge to corporation tax via group relief. Any losses unrelieved in the year are available for carry forward against future profits of the company on a restricted basis. The loss restriction limits to 50% the amount of profits against which brought forward losses in excess of 5 million GBP can be offset. The 5 million GBP de minimis applies to income losses and capital losses in aggregate, and on a group basis.

Where corporate investors previously within UK income tax become subject to corporation tax on rental income, existing unutilised income tax losses will be available for carry forward and offset against future UK property business profits (and relevant profits that arise from loan relationships or derivative contracts) of that company, without restriction. However, those losses will not be available for offset against other types of income or for surrender as group relief.

Permanent establishment

A non-resident company has historically only been subject to UK corporation tax if it carried on a trade through a PE in the UK (see section "*Tax treatment of disposals*"). A non-resident company that acquires UK real estate as a long-term investment to obtain rental income and long-term capital appreciation would not normally be considered to be carrying on a trade in the UK.

Consequently, if a non-resident company carried on trading activities elsewhere in the UK, then it may have been preferable for it to invest in UK real estate via a separate company.

A non-resident company will not be resident in the UK for tax purposes unless it is managed and controlled in the UK. This will not normally be the case if the majority of the directors of the company are resident outside the UK, and they hold their board meetings outside the UK.

However, a number of significant changes have been made in recent years which means that non-resident companies are also subject to UK corporation tax on the trading profits attributable to a trade of dealing in or developing UK land (irrespective of whether there is a UK PE), and on profits of a UK property business and on gains on direct or certain indirect disposals of UK immovable property.

Investment in real estate via a local company

Assessment of UK rental income

For UK resident companies, rental income from UK real estate is chargeable to corporation tax. The income is calculated in the same way as for income tax (see section "*Corporate investment in real estate directly by non-resident investors/Basis of assessment*" above) but is calculated for the accounting period of the company (see section "*Period of assessment*" below). However, relief for interest is given separately (see section "*Corporate investment in real estate directly by non-resident investors/Financing costs*" above).

Rental losses may be used to offset other profits of the company. Any excess may be used to offset other group companies' profits. Any losses unrelieved in the year have historically been available for carry forward in full

against future profits of the company without time limit. Losses may not be used for offsetting or carried forward where they arise from any part of the business that is not conducted on a commercial basis.

However, from 1 April 2017, measures were introduced which restrict to 50% the amount of profit which a company can offset through losses carried forward. The loss restriction limits to 50% the amount of profits against which brought forward losses in excess of 5 million GBP can be offset. The 5 million GBP de minimis applies to income losses and capital losses in aggregate, and on a group basis. In addition to the expenses deductible from rental income, a UK company that invests in real estate may deduct the expenses of managing its portfolio of investments, and interest payments and related costs. The expenses can be deducted from any income or gains earned by the company. Any excess expenditure can be used to offset other group companies' profits and/or carried forward without time limit to be used to offset income and gains earned in future accounting periods, subject to the 50% restriction rule referred to above

Profits on foreign lettings are calculated in the same way as UK lettings, but are assessed separately. Losses on foreign lettings can only be carried forward against future profits on foreign lettings.

UK tax on rental income

A company resident in the UK will be subject to UK corporation tax on its net property business profits at the normal corporation rate which is currently 19%.

Period of assessment

The period of assessment will be the same as the company's accounting period, so long as this period does not exceed 12 months. If the accounting period exceeds 12 months, then it will be split, for tax purposes, into two separate periods, with the first period consisting of the first 12 months of the accounting period, and the second period consisting of the remainder of the accounting period.

Companies must usually file their tax return (along with accounts) within one year from the end of the period of assessment; the return must include a self-assessment of the tax payable.

Corporation tax self-assessment (CTSA)

The corporation tax self-assessment (CTSA) regime applies. Some of the significant features of CTSA are outlined below.

Taxpayer's duty to assess tax

Under CTSA, the burden of correctly assessing a company's tax liability rests with the taxpayer. A tax return will constitute a clear statement that the amount shown on a self-assessment is the correct amount of tax payable, rather than an opening position in negotiations.

A tax-geared penalty of up to 100% will apply to negligent submission of incorrect returns. Where a HMRC enquiry identifies adjustments to a company's self-assessment, if a company is not able to show that it had nevertheless exercised reasonable care in assessing its tax, it may face a negligence penalty.

Quarterly payments

Large companies, broadly those with taxable profits exceeding 1,500,000 GBP, are required to pay tax by quarterly instalments. Instalments are based on estimates of the current year's tax position, and are due in the 7th, 10th, 13th and 16th months following the start of the accounting period. Interest is charged on underpaid quarterly tax, and penalties can apply in some cases.

The 1,500,000 GBP threshold referred to above is reduced to take into account associated companies. There are special rules where companies cross this threshold.

For accounting periods beginning on or after 1 April 2019, the largest companies with profits over 20,000,000 GBP million will have earlier quarterly payments dates, with tax due in the 3rd, 6th, 9th, and 12th months of the period concerned.

Where the accounting period is shorter than 12 months, special rules apply to modify the payment dates referred to above.

Documentation

Under CTSA, taxpayers have a statutory duty to keep and preserve such records as may be needed to enable companies to deliver a correct and complete return. The definition of the records required is extensive.

Corporation tax continues to be payable nine months and one day after the end of an accounting period for those companies with taxable profits not exceeding the large company threshold.

Financing costs

Interest is deductible on an accrual basis, subject to a number of potential restrictions which can result in interest being disallowed in full or in part, or timing of the relief deferred. Some of the key restrictions are mentioned below.

Where the loan is undertaken for the purposes of a trade, the interest will be deducted as a trading expense of the company. Where the loan is entered into for non-trading purposes, such as property investment, the interest will be relieved against other income earned in the period. Where the interest payable exceeds taxable income of the period, it can, subject to certain limitations, be relieved against interest receivable in the preceding year, surrendered in the year to other group companies as group relief, or carried forward for set-off against future income indefinitely. For a discussion of the distinction between trading and investing in real estate, see section "*Trading in real estate*".

Under transfer pricing rules, interest paid to, or guaranteed by, a non-resident parent or related person, will only be deductible where the rate of interest and the amount of the debt are on an "arm's length" basis. Where interest is payable to a non-resident person who is not within the scope of UK corporation tax in respect of the interest receipt, a deduction may only be available once interest has been paid.

Since April 2017, interest has also been subject to the corporate interest restriction introduced in accordance with the OECD's base erosion and profit shifting (BEPS) project. These rules are complex and not discussed in detail here. However, the starting point is to restrict finance cost deductions to 30% of tax EBITDA. There is also a 2 million GBP de minimis and the option of using an alternative group ratio or a public infrastructure exemption if this will provide a better result. In addition, the net interest deduction of the UK group cannot exceed the net interest shown in the worldwide group's consolidated financial statements.

Other potential restrictions include:

- hybrid mismatch rules which implement the OECD BEPS Action 2 proposals can deny interest relief (and potentially other payments) where there are hybrid instruments and/or hybrid entities;
- reclassification of interest as a distribution where the debt has certain equity characteristics; and
- denial of relief where a loan relationship of a company has an "unallowable" purpose (broadly, a purpose that is not within the business or commercial purposes of the company).

Capital allowances

The rules for deducting capital allowances are generally the same as those set out above in relation to income tax.

While not strictly a capital allowance, contaminated land remediation relief is available to companies subject to corporation tax (both UK resident and non-resident) incurring qualifying expenditure. Provided the relevant conditions are satisfied, the legislation entitles a company carrying on a trade or property business to claim an additional 50% relief for "qualifying land remediation expenditure" allowed as a deduction in computing its profits.

The relief is given as a deduction in the company's trading or property business income computation for the accounting period in which the qualifying land remediation expenditure is allowed as a deduction.

Where a company incurs a loss and is unable to benefit from a further deduction for land remediation relief, a qualifying land remediation loss, that company may receive a payable tax credit in exchange for any qualifying land remediation loss surrendered to the Exchequer. The land remediation tax credit is equal to 16% of the qualifying land remediation loss surrendered.

Repatriation of profits

Dividends paid by UK resident companies are not subject to any withholding tax under domestic tax law, with the exception of dividends paid by real estate investment trusts (REITs) – see section below.

UK REITs

REITs are a type of quasi tax transparent property investment vehicle in the UK, similar to certain types of property investment vehicles in other countries (eg, US REITs). Companies meeting the requirements are able to join the regime.

Key features of a REIT

There are a number of requirements to be met by companies in order to qualify as a REIT. In particular:

- The regime is open to companies resident in the UK, which are publicly listed on a recognised stock exchange (which includes the Alternative Investment Market, or AIM, and certain overseas exchanges) The REIT must be admitted to trading either on the main London Stock Exchange (LSE) or a recognised stock exchange as defined in section 1177 of the Corporation Tax Act 2010 (which 2012 includes AIM) and either listed on the LSE (or foreign equivalent main market exchange) or traded on a recognised stock exchange.
- For new REITs there is a grace period of three accounting periods (up to three years) for the shares to be admitted to trading on a recognised stock exchange. If the company or group is not listed at the end of the third accounting period, it is deemed to have left the REIT regime at the end of the second accounting period.
- The company must not be “close” (ie, in broad terms not controlled by five or fewer persons) or an open-ended investment company. Where a new REIT is formed it can be “close” for the first three years. If it remains close at the end of three years it leaves the REIT regime at the end of year three.
- The rules defining whether a company is “close” are relaxed for REIT purposes and shares held by qualifying institutional investors (including charities, sovereign wealth funds, pension funds and authorised unit trusts) are disregarded.
- The company must only have one class of ordinary shares in issue and the only other shares it may issue are non-voting fixed-rate preference shares which may be convertible into shares or security.
- The company must not be a party to a loan that carries excessive interest or interest dependent on the results of the company's business or provides for repayment of an excessive amount.
- There is a requirement that the majority (at least 75%) of the REIT’s activity relates to a qualifying property rental business, by reference to both its total income and assets. For the purpose of the assets test, under changes not yet enacted all cash (and certain cash equivalents, eg, gilts) are good assets.
- There is a requirement to distribute (subject to company law requirements) 90% of the profits (as defined) of the property rental business arising in the accounting period, by way of dividend, on or before the corporation tax return filing date for the accounting period. It is possible to satisfy the distribution requirement by the payment of a stock dividend.

Tax treatment of a REIT

Key aspects of the taxation of REITs include the following:

- Companies that meet the REIT eligibility criteria as set out in legislation will not pay corporation tax on qualifying property rental income or qualifying chargeable gains that relate to the ring-fenced business.
- With certain exceptions basic rate tax (currently 20%) will be withheld on the distribution paid to investors out of the profits of the tax-exempt business, subject to the provisions of any relevant DTT, which may enable all or part of the withholding tax to be reclaimed. There is no provision for reduced treaty rates to be applied at source.
- The REIT is subject to an interest-cover test (as defined) on the tax-exempt part. Failure of this test will result in an additional tax charge rather than exclusion from the regime. “Finance costs” for the purposes of this test did include all debt costs including swap break costs which often led to breaches. Following several amendments, finance costs are now limited to interest and amortisation of discounts relating to financing.
- Since 1 April 2017, REITs have been subject to the new finance cost restriction rules (see above), subject to certain modifications to take into account the REIT regime. In particular, rather than the restriction requiring the REIT to distribute more profit, there is an option (or in some cases it is mandatory) to treat the restriction as taxable income.
- In relation to income and capital losses in relation to the ring fenced business, the general corporation tax loss restriction rules are disapplied.
- Where dividends are paid to a company who holds more than 10% of the share capital, dividends or voting power, the REIT itself may be subject to an additional tax charge, depending on how the holding is structured.

The purpose of this is to prevent a loss of UK tax revenues as a result of a potential reduction in the withholding tax rate available to such investors under the relevant DTT. In practice REITs may mitigate this charge by taking various steps to avoid the payment of such dividends, which may result in restrictions imposed on such investors.

Since 6 April 2019, a REIT has been wholly or partly exempted from corporation tax on qualifying disposals of shares in UK property rich companies (ie, which derive at least 75% of their value from UK land).

Tax treatment of investors in a REIT

A distribution from the tax-exempt profits of a REIT (a property income dividend, or PID) will be taxable as property income (in the case of a shareholder, chargeable to corporation tax) and as profits of a UK property business (in the case of a shareholder, chargeable to income tax). In the case of a non-resident shareholder, a liability to tax will be calculated as if that shareholder were a UK resident, subject to the presence of any relevant DTT.

Where a REIT investor is a UK resident company the PID is paid gross, without any withholding of tax. This income is taxed as if it were rental income at the investor's tax rate. A non-resident company investor would be paid under deduction of withholding tax (currently 20%) and may be able to reclaim some or all of the withholding tax under a DTT. The investor may then be subject to tax on that income under the laws of the investor's country.

Certain investors including a UK gross fund, local government body and a UK resident charity can be paid gross, and may not be taxed on the income from a REIT. However, it is the responsibility of the investor to notify the REIT that it can be paid gross: otherwise the REIT must withhold tax on PIDs.

Ordinary (non-PID) dividends from a UK REIT are paid gross but may be subject to tax in the investor's country.

Where gains are distributed by the REIT to a company investor, the distribution is a PID and is treated in the same way as a distribution of property income, as set out above.

Where a REIT investor is an individual, then the PID will be paid under deduction of withholding tax. A UK tax resident individual is taxed on the gross distribution (including the withholding tax paid) as if the income was rental income. The distribution is taxed in the UK at up to 45%, with credit for the withholding tax. REIT shares can however be held in an individual savings account (ISA). A non-resident individual investor may be able to reclaim some, or all of the withholding tax deducted from the PID under a relevant DTT and may also be subject to tax on that income under the laws of the investor's country.

Ordinary (non-PID) dividends from a UK REIT are paid gross but may be subject to tax in the investor's country.

Where gains are distributed by the REIT, the distribution is also a PID, and is treated in the same way as set out above.

Property authorised investment funds (PAIFs)

Property authorised investment funds (PAIFs) were introduced from 1 April 2008.

Although in some respects they are similar, PAIFs differ in a number of ways from REITs. They are established as open-ended authorised investment funds and are non-UCITs retail schemes (NURS). Like a REIT, a PAIF is a tax-free property investment vehicle, so that tax is not levied on property income in the vehicle itself, but on the end investor, thereby offering, for the first time, tax-efficient investment in property for exempt investors through an authorised investment fund. However, like REITs, non-exempt investors will be subject to a 20% withholding tax on their property income distributions.

Legislation was introduced in September 2016 to provide relief from SDLT on the initial "seeding" of real estate to the PAIF, subject to certain conditions being met.

Disposal of real estate

Legal considerations

Although the residential market is highly regulated in the UK, mainly as a result of past social policy, the commercial market is relatively flexible, and the majority of real estate can be transferred quite easily under a system that requires the registration of most property interests (at a central Land Registry).

While a lease may offer potential flexibility in terms of assignment and the creation of subleases, there are a number of issues particular to the UK that need to be taken into account when considering disposals of leasehold, as opposed to freehold, real estate.

First, on disposal of the leasehold property, the selling tenant may remain liable for the performance of the covenants in the lease, including the covenant to pay the rent, because of complex enforcement arrangements that arise in this context under English law. In other words, the lease is a contract that may create a link so durable that its disposal may not relieve the selling tenant of its responsibility for the performance of its original leasehold obligations (which the landlord will seek to enforce if the new tenant defaults). The original (or in newer leases, only the previous) tenant is effectively rendered an insurer of the lease, which means that it must take care to dispose of its interest in the lease to a reliable and creditworthy person. It is therefore important to consider this potential liability when considering the contingent liabilities of a company that has had previous dealings with leasehold property in England and Wales, particularly since landlords may look to former tenants for recourse in place of a current tenant who is insolvent.

Secondly, if a tenant's automatic statutory right to a new lease is specifically not excluded when a lease is granted, the tenant may, if it remains in occupation and uses the real estate for the purposes of a business, remain in the property at the end of the lease and request a new lease. The landlord may be able to resist this if it can prove that it requires the real estate for certain limited purposes, eg, its own use, or intends to redevelop it, or is willing to relocate the tenant.

Thirdly, the permission of the landlord may be required before a tenant can dispose of leasehold real estate.

More detail is given in the section "*Legal summary and glossary of legal terms*".

Tax treatment of disposals

The motive for acquiring and holding UK real estate is of paramount importance when determining the UK tax consequences of a disposal. The motives of an investor investing in UK real estate can be split into three main categories:

- The real estate is acquired and held as an investment to generate rental income and long-term capital appreciation.
- The real estate is acquired as a capital asset for use by the owner in carrying on its trade.
- The real estate is acquired with the principal object of realising a gain from a disposal of the real estate.

Gains made on disposals under the first two situations above are taxable as chargeable gains. Gains made on disposals under the third situation are taxable as trading income.

The taxation of chargeable gains and trading income are dealt with separately below.

ATED and ATED related gains

Since April 2013 UK residential property worth more than 2 million GBP in April 2012 and owned through an "enveloped structure" (ie, owned by a company) has been subject to the annual tax on enveloped dwellings (ATED), with the level of the ATED charge varying subject to the value of the property.

The threshold for charge reduced to 1 million GBP from April 2015 and to 500,000 GBP from April 2016.

Any post 5 April 2013 capital gains realised on the disposal of enveloped properties were, until 6 April 2019, subject to CGT at 28%. From 6 April 2019 the ATED gains regime has been abolished (as it has now been superseded by the non-resident capital gains regime (see section "*2019 NRCG regime (NRCG)*").

The ATED rules apply to certain NNP, including companies (UK and non-tax resident), partnerships with corporate partners and collective investment schemes. Trustees are however excluded.

Residential properties which are let to third parties on a commercial basis or are part of the stock of a property trading company are outside the scope of ATED, and there are exemptions for job related accommodation, farmhouses, properties open to the public, properties held for charitable purposes, Equity release schemes and where properties are acquired for demolition or conversion to non-residential.

Chargeable gains

Introduction

UK resident companies and individuals are subject to UK tax on their worldwide chargeable gains from real estate (corporation tax for companies and CGT for individuals). The taxation of gains by UK residents, other than companies, is outside the scope of this summary. Chargeable gains realised by a UK company are subject to UK corporation tax at the normal corporation tax rates (see section "*UK tax on rental income*").

The UK did not historically tax non-residents on gains on the disposal of UK commercial property, unless the investor carried on a trade in the UK through a PE, and the real estate was connected with, or held for the purposes of the PE. Certain non-resident investors have however been subject to UK tax on certain residential property gains for a number of years under the 2015 residential property regime (see section below) and the ATED gains regime (see section above).

From 6 April 2019, the scope of the UK's taxation of gains accruing to non-residents was extended to include all gains on direct and certain indirect disposals of UK property, on or after 6 April 2019 (see section "*2019 NRCG regime (NRCG)*").

Computation of chargeable gains/losses

Chargeable gains are calculated as the excess of disposal proceeds, net of incidental costs of disposal, over the base cost of the chargeable asset.

The base cost will ordinarily include the original cost of acquisition, any incidental costs relating to the acquisition and enhancement expenditure. Indexation allowance is also available to UK companies, although is "frozen" as at December 2017. Indexation allowance is calculated by reference to the rate of inflation during the period of ownership. For example, if real estate is acquired for 10 million GBP, sold three years later, and the UK retail price index increases by 10% during the period, the indexation allowance would be 1 million GBP.

The indexation allowance can only reduce a capital gain to nil. It cannot create or increase a capital loss.

For non-resident investors taxed under the non-resident capital gains (NRCG) regime (see section below), the market value of the property at 6 April 2019 (or 6 April 2015 for certain residential property) may replace the original cost of acquisition as base cost.

The base cost will be reduced by the amount on which the SBA has been claimed. Capital losses are also restricted where other types of capital allowances have been claimed.

Capital losses

Capital losses made on disposals of real estate can only be used to offset chargeable gains made in the same period or future periods. The offset of capital losses against chargeable gains may be restricted in certain cases, eg, where a loss arises on a connected party disposal or where there is no real commercial disposal, and where there has been a change in the ownership of the company.

Excess capital losses can be carried forward without time limit, subject to certain restrictions applying to companies. Capital losses of companies are subject to a maximum carry forward of 5 million GBP plus 50% of the current year chargeable gains in excess of that amount. The 5 million GBP de minimis applies to income losses and capital losses in aggregate, and on a group basis.

Rollover opportunities

Chargeable gains, arising on real estate where the real estate is held as a capital asset that is used in a trade, can be rolled over against new qualifying acquisitions within certain time limits, so long as the new asset is also used by the owner for the purposes of a trade. Depending on the nature of the new acquisition, the tax cost of the new asset may be reduced by the chargeable gain arising on the old asset, or the gain may simply be deferred for a number of years.

2015 residential property regime

UK residential property disposed of by certain non-residents between 6 April 2015 and 5 April 2019 has been within the scope of UK CGT by virtue of the 2015 residential property regime. The non-residents affected include individuals, trustees, the personal representatives of non-resident deceased persons and "narrowly controlled" companies.

The 2015 residential property regime covered gains realised between 6 April 2015 and 5 April 2019 and the rate was 20% for companies and 28% for trustees. Individuals were subject to CGT at rates of 18% or 28%, determined by their total UK source income and chargeable gains in the tax year of disposal.

Where ATED CGT provisions applied to companies owning UK residential properties (see above), the ATED charging provisions took precedence over residential NRCG.

Residential NRCG did not apply to communal residential accommodation, such as schools, armed forces homes or institutions, hospices, prisons, hotels, inns purpose built student accommodation or similar establishments, and disposals of UK residential properties by qualified institutional investors (pension funds, sovereign wealth funds, financial institutions, etc) were outside the scope of charge.

2019 NRCG regime (NRCG)

From April 2019, non-residents are charged to UK tax on chargeable gains on direct and certain indirect disposals of all types of UK immovable property, extending the existing rules that applied only to residential property.

Broadly, the indirect disposal rules apply where a person makes a disposal of an entity in which it has at least a 25% interest (or any interest in certain collective investment vehicles (CIVs)), where that entity derives 75% or more of its gross asset value from UK land. Disposals of interests in entities where the property is used in a trade are excluded from the charge, subject to certain conditions being satisfied.

The gain or loss is calculated by reference to the market value (of the asset being disposed of) on 5 April 2019, with the option to use the original acquisition cost. However, where the original acquisition cost is used in the case of an indirect disposal, and this results in a loss, this will not be an allowable loss. There are also transitional rules that apply in the case of direct disposals of UK residential property that would previously have been within the charge to UK tax prior to 6 April 2019.

There is a trading exemption, so that disposals of interests in property rich entities where the property is used in a trade, and the relevant conditions are met, are excluded from the charge. This applies where, for example, a non-resident disposes of shares in a retailer which owns premises with significant value.

There are also “linked disposal” provisions, which mean that where there is a sale of more than one company in the same transaction, the assets of all the companies are aggregated for the purposes of the 75% UK property rich test. Where the 75% test is not satisfied on an aggregate basis, the non-resident gains charge will not apply, even where on an individual company basis, the 75% UK property rich test would be satisfied.

Existing reliefs and exemptions available for capital gains are available to non-residents, with modifications where necessary. These include the substantial shareholdings exemption (SSE) and exemptions for reasons other than being non-resident (for example, overseas pension schemes (as defined) and certain charities). The provisions of any relevant DTT also need to be considered.

All non-resident companies (including certain CIVs), which are treated as companies) will be charged to corporation tax on gains at a rate of 19%.

Non-resident individuals and trusts (unless treated as companies) will be subject to CGT. There are different rates of tax, eg, depending on whether there is a direct disposal of residential property, and whether there is other taxable UK income.

Individuals and trusts (other than those trusts which are treated as companies) need to notify HMRC, and pay any tax due, within 30 days of the completion of a disposal (subject to transitional provisions where there is an existing requirement to file a tax return).

If there is already an existing relationship with HMRC – for example, through filing a non-resident landlord return in respect of UK property income – there are transitional provisions which mean that payment of tax and submission of the computation in respect of disposals prior to 6 April 2020 may be deferred until 31 January 2021. However, in such cases it is still necessary to file the notification of the disposal within 30 days of the completion of the disposal.

Where a non-resident company which is already within the charge to corporation tax (eg, by trading through a PE in the UK, or, since April 2020, on profits of a UK property business), it will be required to file its tax return within one year from the end of the accounting period, and the payment date for the tax will depend the amount of the company’s taxable profits, the length of the company’s accounting period, and the number of “related 51% companies” (see section “*Investment in real estate via a local company*”).

For non-resident companies which are not otherwise within the scope of UK tax, a strict application of the legislation would result in each disposal by a non-resident company (or deemed company) creating a separate one day accounting period, which, as a result of the quarterly instalment payment (QIP) rules, would mean that tax would be due on the date of the disposal. However, HMRC will apply concessionary treatment in certain circumstances so that any payment of corporation tax will not be due and payable before 3 months and 14 days after the disposal date.

For CIVs and companies that have or expect to have four or more disposals in their financial year, HMRC will disapply the one day accounting period rule and for tax purposes the accounting period will run until the end of the company’s financial year (unless that would result in an accounting period of more than 12 months). This means that the date corporation tax becomes due and payable will depend on the amount of the company’s taxable profits, the length of the company’s accounting period, and the number of “related 51% companies”.

There are special rules relating to CIVs. As noted above, one consequence of falling within the definition of CIV is that non-residents making disposals of interests in these vehicles do not have to have a stake of 25% or more to fall within the charge.

A CIV is defined as something which falls into at least one of the following categories:

- a collective investment scheme as defined in section 235 of the Financial Services and Markets Act 2000;
- an alternative investment fund (AIF) as defined in regulation 3 of the Alternative Investment Fund Managers Regulations 2013 (SI 2013/1773);
- a UK company REIT or, from 10 April 2020, the principal company of a group UK REIT; or
- a non-resident company which has some but not all of the attributes of a UK REIT.

Additional reliefs and exemptions may also apply in relation to the CIVs which are designed to eliminate taxation at both the fund and investor level if certain conditions are met.

Certain offshore CIVs which are formed as trusts or contractual co-ownership arrangements will be deemed opaque for capital gains purposes and subject to corporation tax on direct and certain indirect disposals of UK immovable property.

Where such vehicles meet the "UK property rich" requirement and are transparent for the purposes of UK tax on income (as in the case of most Jersey property unit trusts, for example), they will have the ability to make a "transparency" election to be treated as partnerships for the purposes of UK tax on capital gains.

This election is likely to be beneficial where all investors are tax exempt. However, in other cases disposals by the CIV would trigger disposals at the level of a taxable investor if the election has been made; in those cases, the following exemption election may be more appropriate, particularly in the case of open-ended funds.

Alternatively, an "exemption" election may be made for a qualifying CIV, or a qualifying company which is not itself a qualifying CIV (but is wholly (or almost wholly) and directly owned by a collective investment scheme partnership or co-ownership authorised contractual schemes (CoACS), which in each case is UK property rich.

The effect of the exemption election is to exempt that entity, and any other entities in which it has at least a 40% stake, on direct and indirect disposals of UK property.

The exemption regime is only available to UK property rich funds in order to be able to tax gains at the investor level and there are special provisions under which an investor may be taxed if capital profits are remitted to the investor in a non-capital form. Special taxing provisions apply where the conditions (including UK property rich condition) cease to be met, including provisions where a fund is wound up.

There are various qualifying conditions, not all of which have to be met in all cases, reflecting the different types of funds that invest in UK property. At a high level however, the conditions aim to ensure that the CIV is "widely held" by investors who would not be exempt from UK tax as a result of a DTT.

Trading in real estate

Gains made on disposals, where the real estate is acquired with the principal object of realising a gain from a disposal of the real estate, are taxable as trading profits. If the owner is a UK company, then the profits will be subject to UK corporation tax at the normal rates (see section "*UK tax on rental income*").

Trading profits earned by a non-resident owner were historically only usually subject to UK tax if the owner carried on a trade through a PE in the UK, subject to corporation tax, or exercised a trade in the UK subject to income tax.

Consequently, when deciding whether real estate was acquired for investment or trading purposes, a number of factors are taken into account, among the following:

- length of period of ownership;
- amount of rental profit derived from the real estate;
- method of financing;
- other activities carried out by the taxpayer; and
- the taxpayer's motive.

If the real estate is acquired as a long-term investment, then this should be made clear in any documents that record the acquisition decision, eg, minutes of directors' meetings.

The evidence should make it clear that the real estate was acquired for its income producing potential as well as capital appreciation.

If the acquisition of the real estate is financed partly by loans, then the loans should be of a long-term nature. If the interest payable equals or exceeds rental income in early years, there should be forecasts which show that, say, after the next rent review, rental income will exceed interest and other costs.

If the real estate is held for five years or more, then this period of ownership will usually indicate an investment rather than trading transaction. Longer periods of ownership would be a stronger indication of an investment intention, but the period of ownership alone is seldom conclusive.

The Finance Act (FA) 2016 extended the corporate tax regime to all trading profits attributable to a trade of dealing in or developing UK land (irrespective of whether there is a UK PE). The changes made by FA 2016 relating to trading in UK land fall into four categories:

1. Extending UK corporation tax to non-resident companies which carry on a trade of dealing in UK land or developing UK land (whether or not the trade is carried on through a PE in the UK). The intention is to tax all non-resident traders in UK land on the whole of their profit wherever it arises.
2. Replacing existing "transactions in land" provisions. The rules are designed to ensure that profits from activities which are fundamentally trading in nature are taxed as income rather than capital gains and apply to both direct disposals of land and also indirect disposals (ie, disposals of shares or other assets which derive at least 50% of their value from land).

   The “direct disposals” provisions provide a statutory definition of trading in land (very broadly, where one of the main purposes of acquiring or developing land is to realise a profit or gain).

   The “indirect disposals” provisions will apply when the person making the disposal is party to concerned in an arrangement concerning the development of the land.
3. Introducing a new “anti-fragmentation” rule which may increase the profits charged to UK tax by the value of any “contribution” to the development made by an associated person which is not subject to UK tax.
4. Finally, introducing anti-avoidance provisions to counteract arrangements which are intended to avoid any of the rules mentioned above.

If the owner carries on a mixture of real estate trading and investment, then it may be preferable for the UK investment activities to be carried on in a separate company that does not carry on any real estate trading activities.

Sale of shares in a UK real estate company

From 6 April 2019 and the introduction of the 2019 NRCG regime (see above), gains made on the sale of shares in a UK real estate company by a non-resident investor are likely to be subject to UK tax. Prior to 6 April 2019, gains made on the sale of shares in a UK real estate company by a non-resident investor, who was not carrying on a trade in the UK through a PE, were exempt from UK tax, subject to anti-avoidance provisions. The anti-avoidance provisions (the “transactions in UK land” provisions referred to above) mean that the gain can be treated as income in certain circumstances where the underlying property was acquired or developed with a trading motive. The transactions in UK land provisions apply to both direct disposals of land and also indirect disposals (ie, disposals of shares or other assets which derive at least 50% of their value from land).

From April 2019 however, non-resident companies are charged to UK corporation tax on capital gains on direct and certain indirect disposals of all types of UK immovable property. The indirect disposal rules apply where a person makes a disposal of an entity in which it has at least a 25% interest (or any interest in CIVs), where that entity derives 75% or more of its gross asset value from UK land.

Disposals of interests in entities where the property is used in a trade are excluded from the charge, subject to certain conditions being satisfied.

A buyer of any substantial shareholding in a UK company holding real estate is highly likely to require a thorough investigation of the title to the real estate before completion. This is standard practice and is in addition to the buyer’s usual due diligence exercise in relation to the company. Some leases provide that a change of control in a company could trigger a pre-emption right in favour of a third party or may require landlord’s consent.

Capital allowances

A disposal will often lead to a recapture of capital allowances previously claimed by the seller on plant and machinery.

The purchaser and seller of a building may formally elect how much of the purchase price will be attributable to the plant and machinery within the building. Following changes effective from April 2012 it is likely that an election will be made in most situations. This joint election must be made within two years of the date of disposal of the property.

A disposal does not lead to a recapture of the SBA claimed by the seller, other than indirectly given that the chargeable gains base cost will be reduced by the amount on which the SBA has been claimed.

The amount of the SBA which the buyer can claim will depend on whether the seller has been entitled to claim allowances. Broadly, where a person buys a used building in respect of which a previous owner has incurred qualifying capital expenditure, the buyer (if it satisfies the conditions for claiming the SBA) will be entitled to claim the SBA on the residue of qualifying expenditure (essentially, this is the amount of qualifying expenditure incurred on its construction or purchase less the write-off of 3% a year (or 2% a year before April 2020) since the building was first brought into non-residential use).

Real estate development

Investment or trading?

Although real estate development may often be considered to be a trading activity that is not the case where real estate is developed in order to be held as an investment. The normal rules that distinguish trading from investment will apply (see section "*Trading in real estate*").

If real estate is developed by the entity that intends to hold it as a long-term investment, there should be no taxable development profit in that entity in the UK.

Contracts and warranties

Real estate development will normally involve the owner of the real estate, either alone or in conjunction with a joint venture partner, employing a contractor to carry out the works required. There are various recognised structures for development projects each of which has its own set of risks/benefits.

The contractor may itself undertake all aspects of the construction of the project, or may subcontract certain aspects, such as design or structural engineering. Alternatively, the owner may appoint the contractor for the sole task of construction, and the owner may appoint other professionals needed. Whatever arrangement is chosen, a duty of care as to the quality of construction work carried out, or professional services provided, will be needed in favour of the owner from many of those involved in the project team. Warranties containing the duty of care will be needed in favour of financiers of the project, who may also want security over the project assets, and the first tenants of the property. These collateral warranties enable the holder of the warranty to claim compensation from a contractor or professional who breaches their duty under the warranty, and it would be usual to require the contractor or professional to have sufficient indemnity insurance in this respect.

Planning controls

Most material work and development to real estate, including change of use, requires a statutory consent known as planning permission. This is granted, usually, by the relevant local municipal authority and, once granted, is for the benefit of the property concerned, not for the original applicant. Planning permission for development will usually be conditional upon the works being started within three years. Failure to comply with enforcement action taken by the planning authority can amount to a criminal offence, and an owner or occupier of offending premises can be liable, even if the breach of control was committed by a previous owner.

There is a short period after the grant of planning consent for review, but, subject to this, once granted, planning permission cannot be revoked.

Sometimes planning authorities require some planning applicants to enter into other ancillary obligations that benefit the wider community, such as provision of a roadway or sports facility.

Pre-let agreements

Before beginning a development, a developer may enter into a pre-let agreement, by which a tenant will agree to take a lease of the new property on agreed terms, subject to the development being completed. These agreements cannot usually be terminated by the tenant, provided the agreed works are completed within the pre-agreed period. They are therefore very attractive to the developer investor.

Institutional leases

If the real estate is held as a long-term investment, and leased out to generate rental income, the owner should ensure that any such lease is in a form that is acceptable in the UK market to institutional investors. What will constitute an institutional lease varies according to market conditions. However, it is generally accepted that the lease should be more than ten years, and the annual rent payable should represent a market rent subject to regular upwards-only reviews. Upwards-only reviews aim to take rent to the highest point in the market, and not let it

subsequently drop. The tenant should have full repairing and insuring obligations, and its ability to deal with the lease by outright disposal or the creation of subleases should be restricted (to ensure the quality of the tenant is maintained). The owner must be able to recover anything it spends on the property by way of comprehensive service charge provisions, so that the rent it receives is not reduced by having to pay any expenses in relation to the property.

Value-added tax

Introduction

Value-added tax (VAT) at 20% is payable by UK and non-resident investors on the cost of many goods and services purchased in the UK. VAT at 20% is also chargeable by UK and non-resident investors carrying on a business in the UK, who make taxable supplies of at least 85,000 GBP a year for a UK investor or at any level for a non-resident investor (fixed to March 2020). A business can register voluntarily if the taxable turnover is below this figure. A property developer or investor can also register for VAT on the basis of clear intentions to make taxable supplies in the future – this facilitates recovery of VAT on initial investment appraisal, acquisition and development costs at an early stage. Investing in UK real estate and charging rent is considered to be carrying on a business in the UK for VAT purposes, although these supplies are not always subject to VAT.

Types of supply

Essentially, there are four different liabilities of supplies for VAT purposes:

- For standard-rated supplies, the supplier charges VAT at 20%, and can recover VAT charged on supplies received that directly relate to the standard-rated supply made by supplier.
- For reduced rate supplies, the supplier charges VAT at 5% and can recover VAT on supplies received that directly relate to the reduced-rated supply. The reduced rate relates to domestic fuel and utilities, and certain works related to renovating and converting buildings for use as dwellings.
- For zero-rated supplies (equivalent to the EU exempt with right of refund), the supplier does not charge VAT on supplies, but still recovers VAT charged on supplies made to it that directly relate to the zero-rated supply made by it.
- For exempt supplies, the supplier does not charge VAT, and cannot recover VAT on supplies directly related to the exempt supply.

Certain supplies, broadly speaking exported services, are outside the scope of VAT, with or without right of recovery of the VAT on related costs. For practical purposes, such supplies can be treated as zero-rated or exempt, respectively. The main exception to this rule within the property sector is any services that relate to land situated in the UK, which remain within the scope of UK VAT, regardless of where the recipient of those services is established. Examples of this would be property valuation and surveys, estate management services and physical work performed on real estate in the UK, which would all be subject to VAT at the standard rate of 20%.

Some transactions may fall outside the above categories, as they do not constitute supplies for VAT purposes, for example transfers of property development or investment businesses as going concerns (specific conditions need to be met for the transfer of real estate to be seen as the transfer of a going concern), dilapidations payments, dividends and planning gain improvements.

Real estate supplies

The sale or grant of an interest in real estate is generally exempt from VAT, with the supplier having the option to charge VAT at the standard rate on supplies of commercial real estate. The major exception to this is the sale of the freehold interest in new (less than three years old) commercial buildings, which is automatically standard-rated, along with some other leases and lettings in relation to transactions such as car parking, and hotel and holiday accommodation. Most building work is standard-rated, but the construction of new dwellings and of certain buildings intended to be used for qualifying charitable or relevant residential purposes is zero-rated. VAT is chargeable on supplies of real estate as follows:

Transaction type	VAT treatment	VAT rate (in %)
Construction of residential buildings	Zero-rated	0
Qualifying conversion and renovation works on residential buildings	Reduced rated	5

All other works on residential buildings	Standard-rated	20
The first-time sale, including leases exceeding 21 years (in Scotland, leases of no less than 20 years) of:		
a) a new residential building by the person who constructed it	Zero-rated	0
b) a substantially reconstructed listed residential building by the person who substantially reconstructed it	Zero-rated	0
c) a residential building converted from a commercial building or a renovated residential building, which has not been used as a residential building for at least ten years	Zero-rated	0
Sale (other than the first sale) of a residential building	Exempt	0
Other leases in residential buildings	Exempt	0
Construction of non-residential buildings	Standard-rated	20
Repair and maintenance of any buildings	Standard-rated	20
Sale of freehold interest in a new non-residential building	Standard-rated	20
Sale of an existing (ie, not new) non-residential building	Exempt/Standard-rated	0/20
Grant of a lease in a non-residential building	Exempt/Standard-rated	0/20

For these purposes, a non-residential building is treated as new until it is three years old, counted normally from practical completion. In addition, there are certain categories of leasing and letting, such as the right to park cars, self-storage accommodation in hotels, etc, which are excluded from exemption and are, as a result always standard-rated.

Option to tax

Once a building has been subject to an option to tax, all rents and sales proceeds generated by that building by the person who exercised the option are usually subject to VAT at 20%, although the option to tax may be revoked within six months subject to certain conditions or after 20 years, subject to permission being granted by the tax authorities. The principal exception is where the transaction amounts to a transfer of a business as a going concern, for example if the building is sold fully or partly let. However, permission is needed for the option to tax to be exercised where the landlord has previously made exempt supplies of that property. Without this permission, any option to tax, exercised, will be invalid.

Anti-avoidance provisions may also serve to disapply (suspend) an option to tax in relation to the grant of an interest in a building, where it is a capital item subject to adjustment under the capital goods scheme and is used for exempt purposes to a significant degree (greater than 20%) by a person in occupation, and that person meets any of the following conditions:

- That person is the person who developed/purchased the building and the grant of the interest is a sale/lease and leaseback.
- That person provided finance for the development/purchase of the building.
- That person is connected to someone who satisfies either of the above tests.

If an owner of a non-residential building exercises its option to tax, it will be able to recover VAT charged on supplies made to it that directly relate to the real estate after the date of the election. Some input tax, or a proportion of it, incurred before exercising the option to tax may also be recoverable. The owner will have to charge VAT on rent and on the sale, proceeds arising out of the disposal of the commercial real property. This will not be regarded as disadvantageous to either the tenant or purchaser if they are able to fully recover the VAT. Most business tenants can fully recover the VAT payable on rent. The major types of business tenants who cannot recover VAT are those engaged in banking, insurance, other types of financial services, and the education and health sectors. For these tenants, VAT charged on rent represents an additional cost. Careful planning is required to minimise the adverse effects of VAT. Where an investor does not opt to tax a building and receives exempt rent, the VAT charged on related expenses may not be recovered.

Residential/domestic buildings can never be subject to the option to tax, and so the sale and leasing of such properties is generally exempt. The only exception is the first-time sale of the freehold interest and leasing on leasehold terms exceeding 21 years (in Scotland, leases of not less than 20 years) of new and certain converted,

or qualifying listed, residential/domestic property by the developer, which is taxable at the zero rate. This means that VAT incurred by such developers can be recovered in full, subject to some limited constraints.

Other issues

The VAT treatment of service charges depends on the nature of the service being supplied, and whether the building is commercial or residential. The general rule of thumb is that service charges for general upkeep of the premises or estate generally and the common parts are additional rent, the VAT liability of which follows the liability of the rent itself. Any service charges for services provided into the tenant's demised area are taxed according to its natural liability. For example, cleaning in a tenant's offices in a commercial property will be standard-rated.

It is also common practice for landlords to offer incentives to tenants to take new leases. Cash offered is called a reverse premium and can be held to be consideration for a service provided by the tenant to the landlord if the latter obtains clear benefits in return. For example, the payment could be a contribution towards certain works being carried out by the tenant, or the tenant agrees to upgrade or improve the building.

Other benefits might be that the tenant agrees to be an anchor tenant and so allow its name to be used in advertising. A service of this nature provided by a business tenant is generally liable to VAT at 20%. Such VAT will be recoverable if the landlord has opted to tax, otherwise it will be a cost. Other forms of tenant incentives include rent-free periods and rent reductions. As for reverse premiums, if they are linked to a tenant providing benefits, VAT may also be due on the value given by any rent waived.

However, reverse premium, rent-free periods or rent reduction given to tenants for taking the lease on standard terms are not likely to be regarded as consideration for any supply by the tenants and no VAT will be due.

Irrecoverable VAT will be allowed as a deduction in computing taxable income in the UK, only if the item on which the VAT was charged is allowed as a deduction in computing taxable income.

A foreign resident investor will have to register for VAT if they make or intend to make UK taxable supplies. It will usually be possible for an overseas investor to register for UK VAT from their foreign business address, but if they have no business establishment in the UK, it may be convenient to appoint a VAT agent in the UK.

Transfer taxes

Stamp duty land tax (SDLT), stamp duty and stamp duty reserve tax (SDRT)

SDLT applies to real estate transactions. SDLT is payable on non-residential land transactions at the rate of 5% of the VAT-inclusive consideration to the extent that the consideration exceeds 250,000 GBP only (rather than to the entire consideration). Reduced rates apply in respect of consideration up to 250,000 GBP.

For residential transactions, SDLT is payable at the relevant rate to the extent that the consideration falls within the bands as follows:

Purchase price (in GBP)	SDLT rate (in %)
0 to 125,000	0
125,001 to 250,000	2
250,001 to 925,000	5
925,001 to 1,500,000	10
1,500,001 or more	12

As a result of a COVID-19 SDLT holiday however, the above rates for acquisitions of residential property with an effective date from 8 July 2020 to 31 March 2021 are reduced to 3% for consideration up to 500,000 GBP.

From 1 April 2016, an additional 3% has been applied to these rates in respect of the acquisition of "additional" residential properties, such as second homes and buy to let properties.

The additional 3% applies where, as a result of the acquisition of the UK residential property, an individual purchaser has more than one residential property (anywhere in the world).

The additional 3% also applies to all acquisitions of UK residential property by companies and other non-natural persons.

There are also rules which mean that the acquisition of individual residential dwellings priced over 500,000 GBP by a company or NNP will be subject to a flat rate of SDLT at 15% in certain circumstances.

In addition, a 2% SDLT surcharge on non-residents purchasing residential property in England and Northern Ireland will be introduced from 1 April 2021. The additional 2% SDLT will apply, from 1 April 2021, to both non-resident individuals and NNPs (eg, companies, trusts, partnerships) in addition to the existing residential SDLT rates of up to 15%. Consequently, the top residential SDLT rate for non-residents could be 17%

SDLT is payable on the grant of a lease on any premium at the same rates.

In addition, SDLT is payable at a rate of 1% on the net present value of the total rent under a commercial lease between 150,000 GBP and 5 million GBP and at the rate of 2% on the net present value of the total rent over 5 million GBP.

For a residential lease, SDLT is payable at a rate of 1% on the net present value of the total rent over 125,000 GBP.

Special rules apply where the transfer or grant is for unascertainable consideration, for other property, or to a connected company.

Reliefs are available for certain intra-group transactions and reconstructions, but these are subject to various anti-avoidance provisions and in particular relief is only available where the transaction is effected for bona fide commercial purposes and no tax avoidance is involved.

There is an exemption for the leaseback leg of a sale and leaseback transaction.

There are special rules for charging SDLT where an interest in land is transferred into or out of a partnership, where there is a change in the profit-sharing ratios in the partnership and where an interest in a partnership that owns land is transferred. SDLT is calculated by reference to a proportion of the market value of the land effectively transferred. These rules are complex and specialist advice should be sought.

Where more than one residential property is purchased from the same vendor, the buyer can choose to pay SDLT at a rate determined by the mean value of the properties purchased (subject to a minimum rate of 3%), rather than their aggregate value. (This relief does not apply to residential dwellings that are individually priced at 2 million GBP or greater and such properties must be ring-fenced.)

Note that since 1 April 2015, land and buildings in Scotland have been subject to Scottish land and building transactions tax (LBTT) in place of SDLT. Rates are graduated up to 12%, which applies to a transaction value for residential properties in excess of GBP 750,000 (or up to 16% where the additional 4% for second homes or buy-to-lets applies), and up to 5% for non-residential properties.

Since 1 April 2018, land and buildings in Wales have been subject to Welsh land transactions tax in place of SDLT. Rates are graduated up to 12%, which applies to a transaction value for residential properties in excess of GBP 1.5 million GBP (or up to 15% where the additional 3% for second homes or buy-to-lets applies), and up to 6% for non-residential properties.

Stamp duty or SDRT is payable on the sale of shares in a UK incorporated company at the rate of 0.5%. There is a time limit of 30 days after a relevant transaction in which these taxes should be paid (reducing to 14 days from April 2019), otherwise penalties and interest for late payment become due. In the case of SDLT, a special return needs to be submitted with a self-assessment of the tax.

Since 1 December 2003 transfers of assets other than land, stock, or marketable securities and partnership shares are exempt from stamp duty.

In certain circumstances it may be possible to mitigate these charges. Accordingly, specialist advice should always be taken.

Registration fees

A small UK Land Registry fee up to a maximum of 910 GBP per property will be payable on the transfer of registerable land.

Other real estate taxes

Business rates

The only local property tax for any commercial real estate is the business rates (also known as national non-domestic rate, or NNDR). This is normally payable by business occupiers and is not a concern to landlords unless

the property is vacant. Residential real estate investors can be subject to council tax, which is levied by local authorities, but again this will normally be a concern only when the dwelling is unoccupied.

This information relates primarily to England and Wales but there are broadly similar systems in Scotland and Northern Ireland, though there are some differences.

The NNDR is based on a multiplier, which is set each financial year (commencing 1 April) by the central Government.

For 2020/21 the standard multipliers are 51.2% for large businesses and 49.9% for small businesses. Large properties are defined as those with a rateable value of 51,000 GBP or above. The 2020/21 multiplier in Wales is 53.5%, there is no small business multiplier.

In addition, from April 2010, the Mayor of London introduced a levy of 2% of rateable value for non-domestic properties with rateable values above a set threshold (currently 70,000 GBP). This will help pay for Crossrail, the new east-west train link.

Rates are charged annually to business occupiers, and since 1 April 2008 they have also been applicable to vacant property in which case they are charged to the owner.

The rateable value is defined as the hypothetical annual rent that would be payable on the open market under a full repairing and insuring lease. A rating valuation exercise took effect from 1 April 2017, and the basis for the rateable value is the annual rental value as at 1 April 2015. Rateable values are assessed and published in a rating list by the Valuation Office Agency (part of HMRC).

The next revaluation is scheduled to occur on 1 April 2023 (using 1 April 2021 as the reference point for the tax) and after that revaluations will occur every three years. However due to COVID-19 the frequency of valuations is currently under review and the date of the next revaluation is subject to change.

Revaluations are usually accompanied by a transitional scheme to lessen the effects of sudden and significant rises in rate bills. The cost of phasing in increases in rate bills is met by limiting the benefits of decreased rate bills by phasing in the reductions.

Transitional schemes are self-financing and seek to provide an appropriate balance between protecting those who experience larger increases in rates bills and allowing those who enjoy a fall in bills to experience the full benefit as quickly as possible. There are no transitional schemes in Wales and Scotland.

A similar scheme operates in Northern Ireland from 1 April 2015, for a four-year period, but this is not related to a revaluation. The scheme phases in any increase in rates resulting from the creation of a number of new local councils. This was necessary because in Northern Ireland the multiplier is made up of a regional rate, set annually by the Northern Ireland Executive, and a district rate set by the local council.

In England and Wales, a small business rate relief scheme was introduced in 2005, for occupiers of a single property and the Government extended the level of relief over recent years, on a temporary basis.

Since 1 April 2017, in England, qualifying ratepayers with rateable values below 12,000 GBP will pay no rates at all, while qualifying ratepayers with rateable values between 12,000 GBP and 15,000 GBP will receive tapered relief from 100% to 0%. There is a buffer zone between 15,000 GBP and 51,000 GBP where eligible ratepayers' bills are calculated using the small business multiplier.

In Wales, qualifying ratepayers with rateable values below 6,000 GBP pay no rates at all, and a taper applies for rateable values between 6,001 GBP and 12,000 GBP.

Other forms of rate relief are available on a discretionary basis, eg, for partly occupied properties such as those under-utilised during periods of phased vacation or occupation. There are also a number of temporary reliefs introduced by the Government which may apply in certain circumstances, eg, flood relief.

In England and Wales, if commercial real estate is vacant for up to three months, no rates are payable, and after three months empty rates are payable at 100% of the normal level. Industrial properties, such as factories and warehouses, are exempt from rates for the first six months when unoccupied, and then the 100% empty rates charge applies.

All unoccupied properties with rateable values of less than 2,600 GBP are exempt from empty rates and there are a number of other exemptions applicable to empty property.

Various exemptions also apply to empty commercial real estate in Scotland and Northern Ireland.

The Government's Localism Act gave local authorities a broad power to grant relief to any local ratepayer however it is not possible to generalise on the circumstances in which this may be granted. In addition to this broad power there are other reliefs which are periodically introduced on a temporary basis.

These temporary reliefs are all subject to European state aid limits.

In 2020, the UK Government announced that in part of its response to COVID-19 all occupied retail, leisure and hospitality properties will be charged zero business rates for the period 1 April 2020 to 31 March 2021. This is not available to empty properties. Charges will resume as normal from 1 April 2021.

Prior to April 2013 local authorities collected business rates on behalf of the Government who then redistributed it in the form of a grant. From 2013 local authorities retain a portion of the rates income and this may influence decisions to grant discretionary relief.

If the real estate is incapable of beneficial occupation, and it can be shown that it is uneconomical to repair, it may be possible to secure a reduction in rateable value to a nominal value. With regard to properties that are the subject of refurbishment and redevelopment schemes, it may be possible to secure a rateable value reduction if the works go to the structure of the property or if the property is part of a wider development scheme that incorporates other properties. It may also be possible, in certain circumstances, to negotiate with the local authority to secure an exemption.

Legal summary and glossary of terms

Introduction

Real estate law in Scotland and Northern Ireland is different in a number of ways from that in England and Wales, although it is usually possible to adopt similar ownership and security structures. English and Welsh real estate law uses several technical expressions. A glossary of the most common of these is set out at the end of this summary.

Types of land ownership

Real estate may be held in the following ways.

Freehold

Freehold land is typically subject to central registration formalities (although a limited amount of land remains unregistered and would become registered on a future transfer). Freehold title is the ultimate ownership of the land and is owned for an unlimited duration. Freehold land may, however, be subject to rights and restrictions in favour of third parties and leases.

Leasehold

Leasehold land is subject to central registration formalities where the lease is granted for a term of seven years or more or has seven years or more left to run when it is transferred.

Generally, leases fall into two types:

- Long leases are usually for at least 50 years at a nominal rent, usually containing limited restrictions and obligations on the tenant. In many cases the tenant under a long lease will effectively be in the same position as if it owned the freehold interest in the land. Usually a lump sum or premium is paid at the outset.
- Rack, or market, rent leases are where a tenant, who usually occupies the property, holds land for a shorter period. As the landlord has a greater interest in preserving the asset and its income, these leases usually contain more obligations on the tenant's part. The great majority of companies and businesses in England hold property under these leases.

A lease will invariably contain a provision enabling the landlord to end the lease (known as forfeiture) if the tenant is in breach of any of its lease obligations, such as non-payment of rent or where the tenant becomes insolvent, bankrupt, goes into liquidation or administration, or has a receiver or administrator appointed. Forfeiture clauses are subject to a statutory right for the tenant to apply to the court for denial of this remedy, or relief from forfeiture, which would normally be granted, subject to the breach in question being corrected.

It is usual for rack rent leases, but not long leases where a capital sum was paid, to contain a forfeiture clause enabling the landlord to end the lease for non-payment of rent.

Commonhold

There is a further form of ownership established by the Commonhold and Leasehold Reform Act 2002.
A commonhold will comprise unitholders (for example residential flat owners, industrial premises on an estate, or

detached dwellings in an enclosed community) having freehold title to their individual units and a commonhold association having freehold title to the common parts. This form of ownership is still quite rare.

Legislation affecting commercial tenancies as a result of COVID-19

Coronavirus Act 2020

Following a full nationwide lockdown in the UK on 23 March 2020 due to the outbreak of COVID-19 cases, emergency legislation, known as the Coronavirus Act 2020, was passed through parliament to coincide with the first rent quarter date of 2020 on 25 March (when most commercial tenants' rent would have been due). The legislation introduced a number of restrictions and reliefs in relation to commercial tenancies due to COVID-19. The most important point for commercials tenancies was that a forfeiture moratorium was introduced, which prevented any forfeiture of commercial leases for non-payment of rent between the "relevant period" which started on 26 March 2020 and currently expires on 31 December 2020 (subject to any further extension by the Government).

The forfeiture moratorium affects most commercial leases and extends to non-payment of any sums due under the lease (not just rent). The legislation is not a payment holiday, and if tenants decide not to pay that rent during the moratorium period, that rent obligation is merely postponed to a later date. It is therefore important for landlords and tenants to have early discussions as to how future rental obligations will be dealt with. Interest on late rent payments under the lease will also still be incurred by the tenant (unless otherwise is agreed between the parties). Landlords can also still forfeit leases for any other breaches (other than non-payment obligations).

The Corporate Insolvency and Governance Act 2020

Due to the forfeiture moratorium, landlords tried to pursue tenants for outstanding arrears via alternative methods (eg, issuing statutory demands and winding up petitions). As a result, the Corporate Insolvency and Governance Act 2020 was passed through parliament, which provided that creditors/landlords may not present a winding-up petition based on an unpaid statutory demand or an unpaid judgement debt in the "relevant period" (currently between 1 March 2020 and extended to 30 September 2020 and subject to further extensions if so required by the Government). This is unless the landlord (as creditor) has reasonable grounds for believing that: (i) COVID-19 has not had a financial effect on the tenant company; or (ii) the tenant company's inability to satisfy the statutory demand or judgement debt was not caused by COVID-19.

Landlords are also not allowed to present a winding-up petition based on the insolvency of a tenant company. This again is unless the landlord has reasonable grounds for believing that: (i) COVID-19 has not had a financial effect on the tenant company; or (ii) the tenant company's insolvency would have existed even if COVID-19 had not had a financial effect on the company.

Voluntary Code of Practice

To further assist landlords and tenants, the Government also introduced a Code of Practice for commercial tenancies on 19 June 2020. The code is not mandatory but has been endorsed by a number of organisations including RICS. The main principle of the code is "transparency and collaboration", and the Government's aim is to encourage landlords and tenants to act "reasonably and responsibly" when negotiating alternative rent payment solutions to deal with arrears during the COVID-19 pandemic.

The business tenant's right to renewal

Unless a special notice is served by the landlord on the tenant prior to the parties entering into a business lease, with such notice being acknowledged by the tenant in a declaration, a business lease will continue, notwithstanding that the expiry of the term originally granted by that lease has passed. The lease will continue until the landlord or the tenant serves a further notice on the other party, either terminating the arrangement or formally requesting a new lease.

A landlord has certain statutory grounds on which to oppose the renewal of a lease by a tenant. There are seven grounds; the most important of these are the following:

- The tenant's persistent failure to perform its obligations under the lease.
- The landlord's intention to redevelop the property, to the extent that it needs occupation in order to carry out that redevelopment.
- The landlord's wish to occupy the property for its own use.

While a renewal of a lease is being negotiated, a landlord or tenant has the right to make application to the court for an interim increase in the rent. The interim rent is usually the same as the rent determined for the new lease and is payable from six months after the renewal request was made until the date the new lease is finalised between the parties.

Environmental considerations

Environmental issues are an important consideration in property transactions in England and Wales. The prospective purchaser or investor will need to know whether they have a potential liability for the cost of a clean-up of land, and whether contamination is likely to have an impact on the value of the land.

The relevant legislation on contaminated land places a duty on local authorities to inspect land in their particular areas, to identify whether or not it is contaminated. Land is said to be contaminated for the purposes of the legislation if it has substances on, under, or in it, which mean that significant harm is caused, or is likely to be caused, or water is, or is likely to be, polluted.

If the local authority considers that the land is contaminated, it is under a duty to serve a remediation notice on an appropriate person, requiring them to clean up the land. Contamination can be present as a result of both current and historical uses at or near a site, and liability for clean-up can be imposed retrospectively.

An appropriate person will be, in the first instance, the person who caused or knowingly permitted the pollution to occur, ie, a class A appropriate person. If a class A appropriate person cannot be found then the owner/occupier of the land, for the time being, will be responsible, ie, a class B appropriate person. Complex rules operate to allocate liability where several parties may be responsible.

Searches can be undertaken to ascertain the degree of risk of contamination, as well as other potential environmental issues such as risk of flooding. In some cases, further investigation may be required, and a range of risk management techniques such as insurance may be considered.

It is also increasingly important to consider energy performance and wider sustainability issues. Two key requirements relating to energy performance are as follows:

- An Energy Performance Certificate (EPC) must be obtained for all new buildings, and on selling or renting out any building. An EPC provides an A to G energy efficiency rating and recommendations on how to improve the energy rating of the building. EPCs are valid for ten years. Since 1 April 2018, it has been required that all premises that are the subject of new lettings have an energy rating of no lower than E.

  From 1 April 2020, the same has applied to all lettings already in place. From 1 April 2023, it will become unlawful to continue letting out any property with an EPC rating of below grade E.

- The UK Government introduced the Carbon Reduction Commitment Energy Efficiency Scheme (CRC) in 2010 with the aim of improving energy efficiency and cutting emissions. The CRC requires organisations using more than a specified amount of electricity to report annually on energy usage and purchase allowances to cover that usage. The allowance price of 12 GBP for 2012 was set in Budget 2011 and future prices are a matter for the annual Budget process. The scheme also features an annual performance league table. The first league table, for the 2010/11 period, was published on 8 November 2011. For many organisations, energy use within buildings will be a major contributor to their performance under CRC, and this should be taken into account in property management decisions.

The impact of sustainability issues is now often considered in relation to lease provisions, for both new and existing leases, leading to the development of so-called “green lease” provisions.

Real estate investment

Land that is the subject of one or more leases, usually rack rent leases, may be purchased by an investor for the benefit of the income, namely the rent receivable under the leases from the tenants. In this case, the owner will be concerned that the property is wholly or substantially subject to institutional leases.

The principal characteristics of an institutional lease may vary with market conditions but are often as follows:

- a term of at least ten years (but leases are often 20 or 25 years);
- no ability for the tenant to end the lease;
- rent increases to the current open market rent at regular intervals usually of five years. Any dispute as to a rent increase is settled by an independent arbitrator. Once increased, the rent cannot go down.
- The tenant is responsible for the lease obligations of the next owner and, in leases granted before 1996, for later tenants also.
- The tenant must hand back the property to the landlord at the end of the lease in good repair, with the tenant paying the costs of any works required to put it into that state; and
- restrictions upon the tenant’s ability to sublet or dispose outright of the lease to ensure quality occupation and use.

A landlord under an institutional lease can usually rely on the full rental income, without deduction, from property for its own purposes, for example to repay a loan, without having to lay out any of the income on matters such as repairs or services to the property.

It is also possible to provide for rental income to be paid by tenants directly to a lender, so that such income can be applied directly in repayment of any loan.

Real estate development

Construction contracts

Property may be purchased for development where the owner will build a new building, which will then be sold to a buyer, who intends to occupy and use it for its own purposes or lease it to tenants under rack rent leases. Usually, developments are carried out under the terms of a building contract that provides for payments to be made periodically to the contractor.

Collateral warranties

It would be usual to take collateral warranties from the contractor and other principal professionals involved in the construction of the development. Warranties for the financier should give the financier the right to take over the development should the borrower fail to meet its loan obligations, creating a duty and liability to the lender. It is usual to require a contractor or professional to take out sufficient professional indemnity insurance cover in this respect.

Planning control

One important factor for a prospective purchaser or investor to consider when buying or investing in property is the impact on the property of planning controls. Planning controls are imposed by statute, but their implementation and enforcement is primarily carried out at the local government level. If a purchaser or investor intends to develop property, either by carrying out building or engineering works, or by materially changing the use of the property, planning permission is likely to be required. If development is carried out without planning permission, the planning authority has power, within certain time limits, to remedy the situation. Failure to comply with enforcement action taken by a planning authority may amount to a criminal offence. An owner or occupier may be liable for breach of planning control, even if the breach were committed by a previous owner or occupier.

Any person may apply for planning permission. The applicant need not necessarily own the land in question, although the owner must be informed of the application. A local planning authority is required to determine the application within eight weeks of the application, or 16 weeks if environmental considerations are involved. The Planning Act 2008 has introduced an independent public body that is responsible for considering and making decisions on nationally significant infrastructure projects.

The Community Infrastructure Levy

The Community Infrastructure Levy is a levy that local authorities in England and Wales can choose to charge on new developments in their area. The money can be used to support development by funding infrastructure that the council, local community and neighbourhoods want - for example new or safer road schemes, park improvements or a new health centre. It applies to most new buildings and charges are based on the size and type of the new development.

Finance

Introduction

Subject to overriding market conditions at any particular time, real estate finance is generally readily available in the UK. Lenders will require professional, independent valuations and the creation of a fixed security, ie, a mortgage, over the property concerned. Other security may also be needed, commonly the payment of rental income into a blocked bank account. The mortgage is likely to impose obligations on the borrower to repair and insure the property, and restrictions on its ability to develop or lease the property. If the borrower fails to make the payments due to the lender, or breaches the provisions of the mortgage, the lender has a number of remedies, including the ability to sell the property itself.

Security

It is common for the owner of real property to be a special purpose vehicle (SPV) set up solely to invest in, operate, maintain and sometimes development the relevant property and for such an entity to grant a debenture that incorporates a number of security interests within the one document. However, security interests are also granted under separate documents sometimes. The typical security interests granted in a real estate financing transaction in the UK are as follows:

- a mortgage or charge over property giving the lender control over the mortgaged or charged property and the rights of an absolute owner over property should the borrower default;
- a fixed charge or assignment by way of security (as appropriate) over other key assets such as bank accounts (to maintain control over all incoming and outgoing cashflows relating to the property, eg, rental income), contractual arrangements (such as lease and other property related documents, management agreements, development documents), fixtures, fittings and fixtures, insurance policies and proceeds, rental income, disposal proceeds, shares and other investments;
- a floating charge over all assets of the relevant entity – to ensure the secured party holds a qualifying floating charge (see section "*Enforcement of security*" below);
- a charge or assignment by way of security over subordinated debt; and
- a charge or pledge over shares in the borrower or property owning SPV.

Other common inclusions to a security package include:

- a guarantee, whereby another person or company (typically a parent company or shareholder with a strong balance sheet) undertakes to fulfil certain obligations if the borrower does not. This may include a full guarantee of amounts loaned, a cost overrun guarantee in development loans, interest shortfall guarantee;
- a deed of subordination pursuant to which the repayment of any debt owed to a group company by the debtor or other all assets security providers are subordinated to repayment of a senior lender;
- a duty of care agreement with any property manager, asset manager and/or development manager; and
- an intercreditor arrangement where there is more than one secured lending arrangement in place.

Taking security

It would be usual, when taking up security, to carry out a due diligence exercise. Key aspects of the due diligence process in respect of real estate lending generally include:

- preparing a legal certificate of title or report on title to summarise all material and relevant legal and title issues arising out of an investigation into the title of any land to be mortgaged;
- obtaining a valuation report in respect of the property and reviewing and obtaining reliance on various technical reports in respect of the property (eg, environmental/ground surveys, measurement surveys, building/site/mechanical and electrical surveys);
- reviewing the constitutional documents of the security and borrower together with any related shareholder, partnership or joint venture agreements to ensure the transaction is permitted and any formalities are complied with;
- financial modelling to identify any cashflow or value risks in respect of the property;
- reviewing the terms of leases to which a property is subject to ensure the terms are on arm's length and commercially;
- financial modelling to identify any cashflow or value risks in respect of the property and testing various financial covenants;
- in respect of developments, reviewing the terms of construction documentation and any pre-let agreements, planning approvals, the development appraisal and the project monitor's report;
- tax due diligence;
- undertaking searches at the appropriate registries to check whether there are any prior charges as well as status of the relevant parties in respect of solvency and litigious claims; and
- dealing with completion formalities and registering the security where necessary.

Enforcement of security

The Enterprise Act 2002 (the Act) came into force on 15 September 2003 and has had far-reaching effects on UK insolvency and security law. Security agreements that were put in place prior to 15 September 2003 were not affected by the new legislation.

The commentary below refers to some of the key changes that were made by the Act.

Lenders

If the borrower fails to meet its loan obligations, then depending on the nature of the security (and sometimes the terms of the security), the secured lender may have the following options:

- take possession and claim the income under any leases from tenants;
- exercise a power of sale in respect of secured assets;
- appoint a receiver, an administrator or a liquidator, for corporate borrowers, or trustee in bankruptcy for individual borrowers, and ultimately sell the property on the open market and use the proceeds of the sale to repay the loan; or
- apply to the court for an order of foreclosure.

Taking possession

A legal mortgagee has a right to possession of the mortgaged property and those with a lesser form of security may have this right contractually under the relevant security agreement. Until the power of sale is exercisable, the right to possession can only be exercised to protect security rather than to enforce. A lender can become a mortgagee in possession by taking physical possession (typically if the property is abandoned) or bringing an action for possession. It's rare that lenders will take possession as taking possession can result in liabilities being incurred in respect of the asset while they are in possession and impose certain duties on the lender in respect of income and profit. As a result, a creditor will normally opt to appoint a receiver or administrator rather than take possession.

Power of sale

A sale by a lender under the statutory power of sale or an express contractual power of sale transfers title to the purchaser subject to interests having priority to the lender's interest but free of any other interests (eg, subsequent mortgages and charges and the borrower's interest). As a result, lenders may choose to sell secured assets themselves even where they have appointed a receiver. A lender has certain duties in respect of the sale of a secured asset under a mortgage or charge (eg, to act in good faith, take reasonable steps to obtain a proper price for the asset, obtain the best price reasonably obtainable, act with reasonable care and skill and act fairly towards the borrower). Although security documents attempt to exclude such duties, the effectiveness of such provisions is questionable.

Receiver

A receiver is appointed for the purpose of selling the real estate covered by the security and, until then, managing it, including collecting rental income. A receiver appointed over all a company's assets is known as an administrative receiver. A receiver appointed over part of a person's property is known as a non-administrative or fixed charge receiver, and is subject to increased statutory duties, therefore, making this type of receivership more expensive for the lender.

Following implementation of the Act, a qualifying floating charge holder (which broadly means holding a floating charge over the whole business) can no longer appoint an administrative receiver unless an exception applies. The exceptions include arrangements through which a single project company incurs debts of 50 million GBP, in which the lender has "step-in" rights to take control of the project. There is also an exception in respect of project companies of an urban regeneration project, a utility project or a public-private partnership project provided the relevant lender has been granted "step-in" rights in respect of the project.

Administrator

An administrator takes over a company's affairs from the directors of the company and is tasked with reorganising a company's business or realising its assets under the protection of a statutory moratorium which prevents creditors enforcing their claims against the company. The amendments under the Act clarified that a key purpose of the administration procedure is to promote the rescue of a company, either as a going concern or through returning greater value to the creditors as a whole than would be achieved under other insolvency procedures.

The Act introduced a new out-of-court route into administration, in addition to the existing court application procedure. A majority of the directors of a company will be able to appoint an administrator after providing notice to lenders and lenders no longer have the right to prevent the appointment of an administrator.

The laws amended by the Act also provide that lenders holding a qualifying floating charge (which broadly means holding a floating charge over the whole business) have the right to appoint an administrator if the security agreement grants this right. The drafting of the security agreement will, therefore, be of vital importance.

Liquidator

A liquidator is appointed by the company itself, or by its creditors to collect, realise and distribute the assets of the company with the company being dissolved at the end of the liquidation process.

Trustee in bankruptcy

A trustee in bankruptcy will be appointed by the court to realise the assets of an insolvent individual.

Foreclosure

A court controlled process whereby the holder of a mortgage may apply to extinguish the security provider's rights to recover the asset on full repayment of the secured debt to the mortgagee (ie, the security provider's equity of redemption) and resulting in the mortgagee becoming the absolute owner of the asset which they may then sell free of the security provider's rights and any lower ranking security holders. By foreclosing, a mortgagee loses its right to claim for the debt owed to it by the borrower. As such the process will only be advantageous where the value of the secured property is greater than the secured liabilities. It is one of the oldest enforcement powers available but now rarely used in practice because the process can be time consuming and expensive, is controlled by the court rather than the mortgagee and foreclosure orders can also be re-opened by the court in some circumstances.

Order of payment for creditors

Following the sale of the assets of the business, the proceeds will be distributed in this order:

- secured creditors under a fixed charge;
- certain moratorium debts and priority pre-moratorium debts (if applicable);
- expenses of the insolvent estate (applicable in administration);
- the prescribed part;
- preferential creditors;
- secured creditors under a floating charge;
- ordinary unsecured creditors; and
- members to receive any surplus (though members will receive nothing if the company is insolvent and creditors may only receive a percentage of the debt owed to them).

Some further explanatory notes are set out below.

Secured creditors under a mortgage or fixed charge

A secured creditor holding a mortgage or fixed charge is entitled to the sale proceeds of the secured assets ahead of other creditors.

A problem arises for such secured creditors in administration where the administrator and the unsecured creditors want to delay any sale of assets. Unless the secured creditor's funding is required to continue the business as a going concern, the administrator may continue the business indefinitely if they believe the company can be saved as a going concern or that delaying the sale of assets will increase the return of value to all creditors as a group.

Moratorium debts and priority pre-moratorium debts

Where certain formal insolvency proceedings commence within 12 weeks of the end of a moratorium, certain debts will be given a super priority in those insolvency proceedings. This includes any debt that falls due during or after the moratorium by reason of an obligation incurred during the moratorium and certain debts that have fallen due before or during the moratorium by reason of an obligation incurred before the moratorium including:

- the remuneration or expenses of the monitor (insolvency practitioner appointed to oversee the moratorium);
- goods or services supplied during the moratorium;
- rent in respect of a period during the moratorium;
- wages or salary arising under a contract of employment and other related obligations such as holiday pay, sick pay and contributions to occupational pension schemes;
- redundancy payments; and

- debts or other liabilities arising under a contract or other instrument involving financial services (this includes most commercial lending).

Expenses of the insolvent estate

In administering an insolvent estate with a view to saving the company, an insolvency practitioner will inevitably incur liabilities with parties that it contracts with to enable the company to continue to operate or provide other necessary services (eg, legal or valuation). As such certain liabilities incurred by the administrator as well as remuneration of the insolvency practitioners (within certain rules) are given a super priority which ranks payment of these expenses above those of preferential creditors, floating charge holders and other unsecured creditors.

The prescribed part (ring-fencing)

A prescribed part (calculated as a percentage of the realised value of the assets of a company that are subject to floating charges net of certain prior-ranking claims and up to a maximum fund 800,000 GBP) must be set aside by the receiver, administrator or liquidator for distribution to unsecured creditors. In administration, such a distribution is on a pari passu basis among all creditors.

A prescribed part need not be set aside where a company's net property (ie, the property available to satisfy floating charge holders) is less than 10,000 GBP. The requirement may be set aside if the cost of distributing the prescribed part of the net property would be disproportionate to the resulting benefit to unsecured creditors, but courts will only accept this in exceptional circumstances.

Preferential creditors

The Act removed the Crown preference for certain debts such as UK tax and VAT, but retained preferential status for certain employee claims and contributions to an occupational pension scheme. That is, under existing legislation HMRC ranks as an unsecured creditor in respect of all taxes owed to it.

Legislation currently scheduled to come into force on 1 December 2020 shall reinstate Crown preference in part for any insolvencies following 1 December 2020. Under the new scheme, HMRC will restore its secondary preferential status in respect of certain taxes which a company has collected on behalf of others, such as VAT, "PAYE", employee national insurance contributions, and construction industry scheme deductions. HMRC will rank in priority to floating charge holders and unsecured creditors but not to ordinary preferential creditors. HMRC will continue to rank as an unsecured creditor in respect of other tax debts which a company owes on its own account, such as corporation tax.

Method of enforcement

Administration is the most frequent method of enforcement under the Act.

Where the commercial deal agreed by a lender includes a full security package, it is essential that it be structured to include a qualifying floating charge to ensure that the lender has the power to appoint an administrator.
A qualifying floating charge holder should also consider requiring notice of the company directors' intention to appoint an administrator and grant itself the right to appoint its own administrative receiver or to choose its own administrator during the notice period.

An administrator owes its primary duty to all creditors compared with an administrative receiver which has some duties to all creditors though its primary duty is to the lender which appointed it. As such, lenders will want to structure transactions to enable it the option of appointing an administrative receiver if the transaction being funded fits within certain exemptions (see section "*Receiver*" above).

Glossary of terms

The following expressions are commonly used in respect of real estate law in England and Wales:

Alienation	The transfer of an interest in a leasehold property, which includes an assignment, underletting, charging of an interest or parting with occupation or possession.
Apportionment	The division of a benefit or a liability between two or more parties according to their proportionate interest following an event that occurred during a payment period. For example, where a lease is sold, often rent will have been paid by the seller for a period in advance. On the sale, that part of the rent that has been paid in advance, and which relates to the period after the lease has been sold, will be apportioned. The buyer will in effect reimburse the seller, and both parties will have paid the rent attributable to their period of ownership.
Beneficial interest	The interest in property of the person entitled to the benefit or enjoyment of the property. The beneficial interest is separate from the legal interest, which is the

	interest of the person who can prove legal title to the property. Legal ownership does not necessarily mean that the legal owner is entitled to the benefit of the property. They may hold the legal interest on trust for the person who is the owner of the beneficial interest in which case the financial rewards of ownership may initially be paid to the legal owner, but they are under a duty to pass them to the beneficial owner.
Best rent	The highest rent that can reasonably be expected by a landlord in the circumstances of a particular case.
Betterment	Any increase in the value of a property as a result of action by the Government, either local or national. This could be positive action such as the construction of a new road benefiting the property, or negative as where restrictions are imposed which have the effect of benefiting the property concerned. It can also mean the value added to a property attributable to an improvement.
Break clause	A clause in a lease which gives the landlord and/or tenant a right to terminate the lease before its contractual expiry date.
Building scheme	A development project in which land is laid out in plots and sold to different purchasers or leased to different tenants, all of whom enter into mutually enforceable restrictive covenants with the common seller or landlord.
Capitalisation	The conversion of a series of net receipts over a period into the equivalent capital worth.
Commonhold	Form of land ownership that combines freehold ownership of a single property within a larger development, with membership of a limited company that will own and manage the common parts of the development. Although most likely to be used in relation to residential flats, commonhold is also suitable for houses and commercial developments.
Common land	Land over which the inhabitants of a particular locality enjoy rights in common with the owner of the land, eg, rights of way and grazing rights.
Completion	The final step in the legal process of transferring ownership of property. It is the point at which the legal documentation evidencing the transfer is signed and dated and when the purchase price for the property is paid.
Consideration	The payment given by one party to a contract to the other, eg, the price paid by the buyer of a property to the seller.
Contract	A legally binding agreement. A contract for the disposal of an interest in land is unenforceable unless it is in writing, contains all the terms of the contract and is signed by or on behalf of the parties.
Covenant	An obligation undertaken by one party and effected by a deed. Covenants will usually be express but can also be implied by statute. Covenants can be entered into in relation to freehold land, as freehold covenants, or in relation to leasehold land, as leasehold covenants. If the covenant requires the person giving it to do something, the covenant is referred to as a positive covenant. If the covenant restricts what the person giving it can do, it is said to be a restrictive covenant. Both the landlord and tenant will enter into covenants that will be set out in the lease. The ability and willingness of the tenant to comply with its leasehold covenants is referred to as the covenant strength, so that a tenant of sound standing may be referred to as being a good covenant.
Curtilage	The ground that is used for the enjoyment of a building.
Damages	Money recoverable by a court action by a person who has suffered loss as a result of a breach of contract or a breach of duty. The amount recoverable depends on the basis of the claim. Damages for a breach of contract will be the amount necessary to put the person suffering the loss back into the position that they would have been in had the breach not occurred.
Dilapidations	Items of disrepair that arise because of a breach of repairing covenants on the part of the tenant or landlord. It is usual for the dilapidations for which the

	tenant is liable to be listed in a “schedule of dilapidations”, which can be served on the tenant at any time during or within an agreed period of time (eg, two months) of the end of the lease.
Disregards	Items that are disregarded and so not taken into account in assessing the value of the property. For example, a lease will usually list a number of matters that are not be taken into account in assessing the rent on a review, such as the fact that the tenant has carried out some improvements to the property (in this example this is important to the tenant so that it does not pay for both the capital cost of the works and then the increase in rental value).
Easement	A right enjoyed by a person over the – usually neighbouring – land of another, or a right to limit the enjoyment of the owner over their land. For example, a right of way would entitle one party to pass over the land of the other. A right of drainage would give one party the right to allow water to drain from their land on to or through the land of the other. A right to light would restrict one party from doing anything on their land that would hinder the access of light to the property of the other.
Engrossment	The formal and final version of a legal document, prepared by a solicitor for signature, once the contents have been negotiated and agreed.
Fixture	Chattels or goods that have been fixed to the land or building so as to become part of that land or building so that ownership passes with the property. A fixture is different from a fitting, which because of its nature and the purpose and method of fixing to the land or building does not become a fixture. Ownership of a fitting does not pass with the land.
Forfeiture	The right of the landlord to retake physical possession of the land and bring the lease to an end because of a breach of covenant on the part of the tenant.
Headlease	A lease held directly from the freeholder, which may be subject to one or more underleases.
Indexation	The automatic adjustment to a rate, price or payment in line with variations in a specific index, eg, the Retail Prices Index, usually to maintain the value of an asset in line with inflation.
Land Registry	The government body that records the ownership and interests in all registered land in England and Wales. The register states the registered title number, includes a plan of the property, and will provide full details of the owner of the land and of all registerable rights benefiting the land and to which the land is subject, including if the property is subject to a mortgage or charge.
Latent defect	A defect that is inherent in the design or construction of a building, and which is not immediately apparent and could not be discovered on an inspection carried out on completion of the building works.
Licence	The lawful grant of a permission to do something that would otherwise not be legal or allowed. The person granting the permission is called the licensor and the person to whom the permission is granted is called the licensee.
Lien	The right to retain possession of the property of another as security for the performance of an obligation, generally the payment of a debt.
Open market value	The price that it might be reasonable to expect to achieve from an unconnected third party for an interest in property at the date of valuation.
Option	A unilateral right created by contract, giving one party the right at some future date either to exercise a right to do something or to require a party to do or not do something.
Outgoings	The costs and expenses incurred by the owner or occupier of a property in connection with its ownership, use, management and maintenance.
Party wall	The wall separating the properties of two adjoining owners, each of which will have certain rights over the wall.
Peppercorn rent	A token rent payable to a landlord under a lease, usually where a premium has been paid for the lease. The existence of a rent, however small, preserves

	certain rights from the landlord. Usually the rent is of a nominal amount, eg, 1.00 GBP, but could literally be a peppercorn (this term has historic meaning).
Portfolio	Collection of properties or other investments held under one ownership.
Possession	Control over land or buildings, either by occupation and use, or in the case of a landlord, by the right to receive rents, if any, and to exercise the rights and duties in connection with the lease.
Practical completion	The time under a building contract when the building is said to be complete in almost all respects and ready for occupation, save for minor defects that can be put right after the development has been handed over without undue interference or disturbance to the occupier. The surveyor, or other supervising officer, will issue a certificate of practical completion, which is a signed statement confirming that in their professional opinion practical completion has been achieved. Once practical completion has been achieved, the owners of the building take responsibility for it and must insure it. Practical completion also usually triggers the release of funds, commencement of any period of defects maintenance and the commencement of any occupational leases.
Pre-emption	A right of first refusal, whereby if the owner of a property decides to sell, the owner must first offer to sell the property to the holder of the pre-emption right.
Pre-let	A legally enforceable agreement for a letting to take effect at a future date, eg, on the practical completion of building works.
Prescription	The acquisition of a right by the unrestricted and continuous exercise of that right for a prescribed period of time. For example, the unauthorised use of a particular access route, without objection or interruption, over a period of 20 years (or in some cases 40), gives the person using that access route the right to use it. Similarly, unauthorised possession of property for a continuous and uninterrupted period of ten years for registered land and 12 years for unregistered land gives the person in possession certain rights of ownership. This is referred to as acquiring title through adverse possession
Priority of mortgages	Where there are two or more mortgages secured on a property, the order in which they are discharged by repayment to the extent that funds are available on a sale of the property or the default of the borrower.
Quarter days	In England and Wales, the days that traditionally are designated in a lease for payment of instalments of rent, being Lady Day – 25 March; Midsummer – 24 June; Michaelmas – 29 September; Christmas Day – 25 December. Local authorities may use 1 January, 1 April, 1 July and 1 October. In Scotland the quarter days are known as term days and are 2 February, 15 May, 1 August and 11 November.
Quiet enjoyment	The right of a tenant to be given possession of the entire property leased to them and to enjoy the property without physical interference from their immediate landlord.
Rack rent	A rent representing the full, or nearly the full, letting value of the property on a given set of terms and conditions.
Sale and leaseback (or lease and leaseback)	An arrangement whereby a freeholder or a tenant sells their interest in a property for an agreed sum and takes back a lease of the whole or part of the property from the buyer. It is a device usually used to unlock and make available capital invested in a property.
Service charge	The amount payable by a tenant under a lease in respect of the services provided by the landlord.
Surety	A person who offers security for the payment of a debt or the performance of an obligation. A landlord may require a surety, or a guarantor as otherwise known, to guarantee the tenant's obligations under the lease, including the obligation to pay rent.
Surrender	The return of the lease to the landlord by the tenant before the contractual expiration date of the lease. The tenant may have to pay the landlord a surrender premium or price for being able to bring the lease to an end early.

	Sometimes the landlord wants the lease to be surrendered and will be willing to pay the tenant a premium, known as a reverse premium, for the benefit of having the lease ended and the property returned at an earlier date.
Zoning	The division of an area into zones for particular uses or activities. This may be done, eg, by a local authority as a part of its planning policy, whereby particular land uses are designated to certain areas of a locality. Zoning is also the method used to arrive at the rental value of a retail space, usually on the ground floor, by dividing up into strips parallel with the main frontage. A different value per unit of space is attributed with each strip corresponding to its relative ability to achieve sales and/or profit. The most valuable space is usually towards the front.

Municipal tax system

Business rates

Local councils levy business rates on the occupiers of all non-domestic property.

Each property has a rateable value, which equates approximately to its annual rental value. A revaluation in England and Wales was carried out with effect from 1 April 2017. The next will come into effect from 1 April 2021 based on annual rental values as at 1 April 2019. In Northern Ireland the current list came into force 1 April 2015.

Since 1 April 2005 there have been two tax rates known as rating multipliers for England. A lower multiplier applies for defined small businesses while a standard multiplier applies to all other businesses. The standard multiplier for 2018/19 is 49.3% of rateable value. This means that a factory with a rateable value of 1 million GBP would pay rates of 493,000 GBP a year to the local authority.

In addition, in April 2010, the Mayor of London introduced a levy of 2% of rateable value on non-domestic properties with a rateable value of over a stated threshold (currently 70,000 GBP). This will help pay for Crossrail, the new east-west train link.

Owners of vacant non-domestic property currently have to pay business rates on empty offices, shops and industrial premises. In England and Wales, the amount payable is 100% of the occupied charge after an exemption period of three months for offices and shops, and six months for industrial property. Different rules apply for Scotland and Northern Ireland.

An exemption applies to all empty properties with a rateable value less than 2,900 GBP.

There are significant opportunities to negotiate allowances, reliefs and exemptions, and to plan for this local tax.

Council tax

Local councils levy a council tax on domestic property such as houses and flats. Each residence is valued according to its market capital value, but values were set in 1993, based on 1991 values, and there are no current plans for a revaluation.

The capital value is then assigned to one of eight bands, from A to H. Band A is for the lowest value houses, worth less than 40,000 GBP. Band H is the highest, for values over 320,000 GBP in England. Wales and Scotland have their own bands.

The local council sets an amount of tax each year for each of the bands. A bill is issued in March, and this can be paid in twelve monthly instalments. There are various reductions available, with the main reduction being a 25% discount for adult persons living alone in a house (except for children). There are also provisions for exemption in certain circumstances, for example properties occupied by students.

Council tax is also levied on empty domestic properties and local authorities now have powers to levy surcharges on long term empty properties.

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All information used in this content, unless otherwise stated, is up to date as of 10 September 2020.

Real Estate Tax Summary

General

On 22 December 2017, President Donald Trump signed the "Tax Cuts and Jobs Act" (TCJA) that lowers business and individual tax rates, modernises US international tax rules, and provides the most significant overhaul of the US Tax Code in more than 30 years. In response to the COVID-19 pandemic and its impact on the US economy, on 27 March 2020, President Trump signed "The Coronavirus Aid, Relief, and Economic Security (CARES) Act," which modifies certain US tax provisions. The summary below reflects the impact of the TCJA and the CARES Act on the aspects of US tax law relevant to a foreign investor investing in US real property. There is still some uncertainty in applying facts of the TCJA and the CARES Act to potential structures and transactions.

A foreign investor may invest in US real property directly, or through a domestic or foreign partnership, limited liability company or corporation. The summary below describes various US tax considerations relevant to a foreign investor in US real property under each of these structural alternatives.

Rental income

If a foreign person is not considered to be engaged in a US trade or business with respect to its real estate activities, and does not elect to be so considered, that person will be subject to US federal income tax of 30% on the gross amount, or a lower treaty rate if applicable. The 30% tax is collected via a withholding mechanism and often referred to as a withholding tax (WHT) of 30%. If a foreign person is considered to be engaged in a US trade or business with respect to its real estate activities, or elects to be so considered, it will be subject to regular tax on its US net rental income at the maximum rate for 2020 of 21% for corporations and 37% of individuals, estates, and trusts (subject to certain additions – see below). In the case of foreign corporations, an additional tax of up to 30% may apply under the branch profits tax (BPT) provisions (subject to reduction under tax treaties).

Interest

Interest expense is generally deductible in calculating US net rental income. However, the TCJA (as revised by the CARES Act) contained significant limitations on the ability of a US taxpayer to deduct interest expense regardless of whether the interest payment is made to a related or unrelated party. Otherwise eligible business interest expense may be limited by an interest stripping limitation. Interest paid, or in certain circumstances deemed paid, to a foreign investor is generally subject to the 30% WHT, or a lower treaty rate. Non-contingent interest paid on portfolio debt from a foreign lender that owns a less than 10% voting interest in the borrower is not subject to US WHT.

Depreciation

Residential rental property is generally depreciable on a straight-line basis over 27.5 years. Commercial real property is generally depreciable on a straight-line basis over 39 years, with 40 years required for foreign-use and tax-exempt property. Land improvements or other components of the property may be depreciable over a shorter period of time, typically 15 years or less. However, costs attributable to land acquisition are not depreciable. Intangible assets, such as goodwill, are amortisable over 15 years.

The TCJA (as amended by the CARES Act) generally provides for immediate expensing by changing the deduction for assets eligible for bonus depreciation so that 100% of the cost of those assets can be taken in the year of acquisition. However, the percentage of a purchase eligible for immediate expensing declines for certain real estate assets beginning in 2023 and is phased out by 2027.

The ability for real property businesses to utilise the immediate expensing will be limited. As a general matter, land and buildings are not eligible for bonus depreciation. Further, although certain improvements to the interior to non-residential real property made after an acquisition may be eligible for immediate expensing, the ability to utilise immediate expensing would not be available if the entity makes an election to treat the business as a real property business to be exempt from the interest deductibility limits.

The new bonus depreciation provisions generally are effective with respect to property acquired after 27 September 2017 and placed in service after that date.

Net investment income tax

The Medicare contribution tax, also referred to as the net investment income (NII) tax, which imposes a 3.8% tax on the unearned income of US individuals (including citizens and residents), estates, and trusts. The tax is assessed on the lesser of an individual's net investment income for the tax year or any excess of the taxpayer's modified adjusted gross income for the tax year over a threshold amount.

Capital gains on the sale of property

Net gains from the sale of real property used in a trade or business, and held for more than one year, generally will be considered to be long-term capital gains, provided such property was not considered to be held primarily for sale. A foreign corporation is taxed at the maximum rate of 21% on gains realised on the disposition of US real property, or on the disposition of a non-creditor interest in a US corporation, the assets of which predominately consist of US real estate, ie, a US real property holding corporation. For 2020 for individuals, the tax rates applicable to long-term capital gains are 20% for the amount of gain in excess of the original cost with respect to assets held for more than 12 months, and 25% for the amount of prior depreciation taken on the property. The 20% rate is reduced to 15% for individuals in the 25%, 28%, or 33% tax brackets and 0% to the extent the taxpayer's taxable income is taxed at 15%.

Generally, 15% of the gross sales price is withheld from the disposition proceeds payable to a non-US investor, unless certain exceptions apply, or a certificate for reduced WHT is obtained. A refund of excess WHT may be obtained by filing a US tax return.

Dividend withholding tax

Dividends paid by a US corporation to a foreign shareholder are subject to the WHT rate of 30%, or a lower treaty rate. The foreign shareholder can receive a refund of any excess tax withheld by filing a US tax return. Distributions in excess of the earnings and profits of a US corporation are generally not subject to tax, subject to special rules for US real property holding corporations. A return of capital, although not subject to tax, can be subject to the 15% WHT if paid by a current or former US real property holding corporation unless a certificate for a reduced withholding is obtained.

Branch profits tax

A foreign corporation that invests directly in US real estate may be subject to the BPT rate of 30%, or a lower treaty rate, on its effectively connected earnings and profits (net of corporate income tax) to the extent not reinvested in certain US assets. The BPT is in addition to the regular corporate tax of up to 21% on the corporation's effectively connected income (ECI). The combined effective rate of income tax and BPT on a foreign entity classified as a corporation for US tax purposes is up to 44.7%%. Domestic corporations are not subject to the BPT. Gain from the disposition of stock in a US real property holding company is generally not subject to BPT. Consequently, mitigating BPT is often an important reason why foreign corporations invest in US real estate through domestic corporations.

Loss carryforward

Effectively connected losses from the operation of a US real property investment by a foreign corporation may offset the foreign corporation's income from other US businesses or effectively connected US real estate investments. From 2018, the unused operating losses that arise after 31 December 2017 may be carried forward indefinitely subject to an 80% annual limitation.

The TCJA limits a taxpayer's ability to utilise its net operating loss deduction to 80% of taxable income (determined without regard to the deduction). For real estate investment trusts (REITs), the limit is applied against real estate investment trust taxable income, determined without regard to the deduction for dividends paid. In addition, the TCJA eliminated net operating loss (NOL) carrybacks but made NOL carryforward in perpetuity. Notwithstanding the foregoing, the CARES Act temporarily modifies the changes made by the TCJA. For example, the 80% of taxable income limit was increased to 100% for tax years beginning before 1 January 2021. In addition, except in the case of a REIT, a net operating loss arising in a tax year beginning after 31 December 2017 and before 1 January 2021 may be carried back five tax years preceding the tax year of the loss.

This 80% limit applies for losses and net operating losses arising in taxable years beginning after 31 December 2017.

Effectively connected capital losses of a corporation may be used only to offset effectively connected capital gains. Unused capital losses may be carried back three years and carried forward five years. Net losses from the sale of real property used in a trade or business are treated as ordinary and can offset other income.

Real estate investment trust (REIT)

A REIT will pay no US income tax if it distributes all of its net income to its shareholders. The dividend WHT rate on REIT ordinary dividends is 30%, subject to reduction by treaty. Capital gains dividends attributable to the sale of real property by the REIT are generally treated as ECI subject to capital gains tax, WHT, and, potentially, BPT. Distributions to a foreign shareholder attributable to gain from the sale of US real property interests will not be treated as ECI if the REIT is publicly traded and the shareholder does not hold more than 10% of the REIT during the year prior to payment of the dividend. In such case, the dividend is treated as a REIT ordinary dividend.

The sale of shares in a REIT by a foreign shareholder will also generally be subject to the capital gains tax provisions. The 30% tax, however, may apply to a non-resident alien present in the US for at least 183 days in the year of sale.

If the REIT is owned 50% or more by US shareholders, and certain other requirements are satisfied, a capital gain from the sale of REIT shares by a foreign shareholder will not be subject to US tax. Note that this does not apply in the case of a complete liquidation of a REIT's shares. In addition, if a foreign shareholder owns no more than 10% of the stock in a publicly traded REIT, and certain other requirements are satisfied, a capital gain from the sale of the REIT shares by the foreign shareholder will not be subject to US tax.

Other taxes

A partnership that has ECI must withhold 21% of the amount of such income that is allocated to a foreign partner that is a corporation for US tax purposes (37% for a foreign partner that is an individual for US tax purposes). The lower rate of 20% and 25% apply to capital gains of partners that are foreign individuals or trusts under US tax principles.

State and local income, franchise and property, and transfer taxes may also be due.

Real Estate Investments

Preface

This guide has been prepared by the PwC's Real Estate team to provide an introduction to the US tax regime that applies to real estate investors. The terms "foreigner" and "foreign person" are used in this discussion to describe either a non-resident alien individual (NRA) or a foreign corporation. Also, the terms "regular tax" and "net basis tax" refer to the regular federal income tax imposed on US business income. These terms do not include the 3.8% NII tax on unearned income, or the 30% US WHT or lower treaty rate imposed with respect to certain US-source, non-business income of a foreign person. Furthermore, the tax planning points, and the rules discussed are not appropriate if the NRA becomes a resident of the US. Also, adverse tax consequences can result if the NRA marries a US citizen.

Tax planning objectives

While estate planning is important for all US taxpayers, it is especially important for NRAs that may have a US taxable estate. Many states also impose death or estate taxes.

Minimisation of annual US tax liability

A foreign person owning and operating US rental real property, or conducting a US real estate development business, will generally be taxable on the net income connected with the US business activity, ie, US business income, in a manner similar to that of a US citizen, resident or corporation. For 2020, the maximum tax rate is 37% for US citizens or residents and 21% for corporations.

A foreign person receiving passive income from the US, such as interest or dividends, is generally subject to a 30% tax (for simplicity's sake, we will use the term "30% tax" when describing the 30% tax on gross income for income not connected with a US trade or business activity or the branch profits tax), if treaty relief is not available.

The 30% tax on dividends will generally be assessed when actual distributions are made from a US corporation. Under the branch profits tax (BPT) rules, the 30% tax will generally be assessed on deemed distributions from a foreign corporation holding US real property, whether or not an actual distribution is made. If a corporation pays 21% tax on its income, and the remaining profits are subject to the 30%, the effective tax rate upon remittance to the shareholders is 44.7%, without taking any applicable state and local income taxes into account.

Repatriation of earnings as deductible interest

If a foreign investor can repatriate the US real property's earnings in the form of deductible interest, or other deductible fees, while at the same time mitigating US WHT on such payments, then the corporation's own US income taxes for the current and/or future years can be reduced or eliminated.

The 30% tax

The objective of repatriating earnings in the form of deductible interest and fees, with reduced or eliminated WHT, is often paramount in a US real property investment structure.

If a US corporation holds the US real property, then a payment of interest by the corporation to a non-treaty investor will generally be subject to a 30% tax.

If a non-treaty investor uses a foreign corporation to hold the US real property, then pursuant to the branch-level interest tax rules (BLIT), the greater of the interest allowable as a deduction or the interest paid by the foreign corporation will generally be subject to a 30% tax.

Despite the 30% tax imposed on the amount of interest paid or deductible, for corporations without treaty relief, the same interest deductions may yield a 21% federal income tax saving. The rate of 21% is the highest marginal US corporate tax rate. In addition, the interest deductions may result in state income tax savings.

Reducing the 30% tax

Foreign investors from countries with more favourable treaties can take deductions for interest paid to shareholders while reducing or eliminating the 30% tax.

Interest qualifying as portfolio debt interest paid and deducted by the US real property business will be exempt from the 30% tax. The portfolio debt instruments owned by the foreign persons receiving the interest will also be exempt from US estate and gift taxes. However, to qualify for the portfolio interest exemption, the interest cannot be paid by a corporation or partnership to a person or entity that owns, directly or indirectly, 10% or more of the voting stock of a corporation or of the capital or profits of a partnership issuing the debt or a corporation that is deemed a "controlled foreign corporation" (CFC) for US tax purposes. Note that the TCJA altered certain ownership attribution rules for determining whether a non-US corporation is a CFC for US tax purposes. As a result of these changes, NRAs should carefully analyse the impact of their ownership of various US investments to determine whether the NRA may have inadvertently caused a non-US corporation to become a CFC. In addition, contingent interest will not qualify for the portfolio debt exemption. Other requirements must also be met for interest to qualify for the exemption.

In the past, non-treaty investors often used companies incorporated in treaty jurisdictions to reduce or eliminate the 30% tax. However, provisions of the BLIT, and rulings issued by the Inland Revenue Service (IRS) starting in 1984, severely limit the ability of foreign investors to continue to use these structures. Furthermore, the Limitation on Benefits (LOB) clause that was incorporated into US tax treaties further limited the ability to reduce this.

Regulations allow the IRS to disregard participation by one or more intermediate entities in a financing arrangement for the purposes of determining the manner in which a foreign person will be subject to tax in the US. Specifically, if the financing arrangement reduces the tax imposed on the foreign person, is pursuant to a tax avoidance plan and involves a related party or parties, or an intermediate entity that would not have participated in the arrangement on substantially the same terms absent in participation by the financing entity, the intermediate entity may be disregarded. For purposes of the WHT, these regulations limit a taxpayer's ability to use conduit entities incorporated in treaty jurisdictions to take advantage of reduced WHT rates.

Repatriation of earnings as distributions

The ability to repatriate earnings as distributions from a corporation holding the US real property without incurring the 30% tax is important because the tax can materially reduce the profits to the foreign investor. If the corporation pays income tax on its earnings, and these earnings are subject to the 30% tax upon distribution, the effective tax rate is about 44.7%.

Mitigating the 30% tax

A treaty investor can reduce or eliminate the BPT or the WHT on dividends, whichever applies. For investors from non-treaty countries, there are only a few ways to mitigate the 30% tax on the repatriation of earnings. If the US real property is held directly by an individual, without the use of a corporation, then the 30% tax on dividends will not apply, but the BPT could apply.

Liquidating distributions are generally not considered dividends. Thus, other than a RIC or a REIT, if all of the real property is sold and the corporation is liquidated, then generally the 30% tax will not apply. However, an accumulated earnings tax is imposed on foreign corporations, with US source income, which accumulates earnings beyond the reasonable needs of the business. The tax is imposed by the IRS, not self-assessed, at the rate of 15% upon the corporation's accumulated taxable income, which is the corporation's adjusted taxable income, less a dividend paid deduction and the accumulated earnings credit.

Minimisation of US taxation through investment in REIT

A REIT is a US corporation or business trust that elects to be taxed as a REIT rather than as a US corporation. As a consequence of electing REIT status, a REIT is entitled to deduct from its income, dividends paid to its shareholders. A REIT that distributes all of its income will pay no US income tax, and therefore, its dividends will be subject to only one level of US tax.

To qualify as a REIT, an entity must satisfy specific statutory requirements related to its income, assets, shareholders and distributions, as well as other matters. The most significant requirements include the following:

- 75% of the REIT's annual gross income must come from rents from real property, mortgage interest, gains on the sale of real estate assets and other real estate related income.

- 95% of the REIT's annual gross income must be from the sources described above plus dividends, interest, gains from securities sales and other passive income.
- At least 75% of the REIT's assets at the end of each quarter must consist of cash, receivables, government securities and real estate assets.
- The REIT must have at least 100 shareholders for at least 335 days of each 365-day year, and five or fewer individuals may not own more than 50% of the value of the REIT during the last half of each year.
- The REIT must annually distribute at least 90% of its net ordinary taxable income. (Any undistributed taxable income is subject to tax at the REIT level.)

An ordinary dividend distribution from a REIT to its foreign shareholder is generally subject to the 30% US WHT, unless the tax is reduced or eliminated by treaty. A capital gain dividend from a REIT to its foreign shareholder is generally treated as a gain from the sale or exchange of a US real estate capital asset for US tax purposes and taxed accordingly. If the recipient of the capital gains dividend is a foreign corporation it may be further subject to the BPT. Note that, however, BPT would not apply on the sale of REIT stock even if it were not domestically controlled. Generally, the Foreign Investment in Real Property Tax Act (FIRPTA) rules requires the REIT to withhold a 21% tax on the distribution. However, exceptions to this 21% tax exist in cases where the REIT is publicly traded and the shareholder did not hold more than 10% of the REIT during the year prior to the distribution, or the shareholder is a qualified foreign pension fund or qualified shareholder. Note that there may be administrative means to reduce the withholding liability to the extent the taxpayer can prove the actual tax due is a lesser amount.

In general, proceeds from the sale of shares in a REIT regularly traded on an established securities market by a shareholder of 10% or less for the prior five years, or shares in a domestically controlled REIT, are exempt from US taxation. A REIT is domestically controlled if less than 50% of the value of the REIT's stock is held directly or indirectly by foreign persons during the five-year period ending on the date of disposition.

Additional desirable features for investors with multiple properties

Where a foreign investor, or group of investors, invests in two or more properties, it is often desirable for them to do the following:

- limit legal liability solely to the property involved;
- offset income from one or more properties with the losses generated by others;
- transfer funds belonging to one corporation to another corporation.

A means of obtaining these features is to form a US consolidated return group. This entails placing each property in a separate US corporation, each owned by a US holding company. The US corporations then elect to file one US consolidated return for federal income tax purposes, reporting the income of all of the companies. Certain states also permit, or require, the companies to file one combined state income tax return.

For most federal income tax purposes, the group is considered one taxpayer and the following general rules apply:

- The companies are jointly and severally liable for the federal income taxes.
- Taxable income and gains of profitable companies in the group are offset by the tax losses of other companies in the group.
- All US corporations owned by the US holding company and meeting an 80% ownership test are required to join in filing as part of the consolidated return group. However, with the consent of the Commissioner of the IRS, a group, may, for good cause, be granted permission to discontinue filing as a consolidated group.
- Gains or losses realised from the sale of a particular member corporation's shares are reported by the parent company and combined with the taxable income or losses of the other group members in the consolidated return.
- Interest income and expense on loans between group members offset each other and, therefore, are not taxed.
- Taxability of intercompany gains and losses is generally deferred until the related asset, buyer, or seller leaves the group.

Alternatively, the objectives achieved through the use of a consolidated group of corporations may be reached through the use of a single corporation that makes each investment in a separate wholly owned limited liability company that is ignored as a separate entity for tax purposes.

Note that a liquidating distribution of earnings from a US holding company to a foreign shareholder may be treated as a taxable dividend if the US holding company has been in existence for less than five years.

Certain rules for taxing foreigners' US real estate income

The taxation of real estate income of a foreign investor depends on whether the investor actually has, or is considered to have, a business in the US. If so, the taxation depends upon whether or not the income actually is, or is treated as, effectively connected with this business, ie, effectively connected income (ECI). The computation of taxable income and the applicable tax rates are quite different if the income is not effectively connected with a US business.

Defining the terms "US business" and "ECI"

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) provides that gains and losses from the sale or exchange or other disposition of US real property interests, including the stock of a US corporation when the majority of its assets are US real property interests, will automatically be considered ECI, irrespective of whether the US real estate investment constitutes a business to the foreign owner.

Facts and circumstances test

A facts and circumstances test applies in determining whether operating income, such as rental income, is income effectively connected with a US business. For purposes of ease, income effectively connected with a US business is also described as "business income".

A foreigner's investment in US real property will generally constitute a US business, as opposed to a non-business or passive investment, if the foreigner is carrying on the management or other operating activities on a regular basis, either directly or through an agent. Therefore, the purchase and subsequent development of a parcel of land for purposes of resale would normally constitute a business. Also, the ownership and leasing of one or more properties could constitute a US business.

If the US investment constitutes a business, it must then be determined whether the investor's different types of income are connected with that business. Generally, US-source income generated directly by the assets used in the business or the activities of the business will be considered US business income. Therefore, the rental income of foreign investors from their US real estate business will normally be ECI. On the other hand, dividend income generated from stock held in a US company that owns US real property generally will in most circumstances not be considered ECI. The determination of a foreign corporation's non-ECI, and the assets that generate such income, has taken on added significance in view of the branch profits tax, because assets included in the federal income tax return as generating US business income may result in a BPT, if subsequently they are disinvested, ie, treated as non-effectively connected.

To avoid the uncertainty of the facts and circumstances test, the US tax statute as well as some income tax treaties with the US provide for an election that a foreign investor can make to treat its US real property investments as attributable to a US trade or business by deeming the income to be ECI.

Taxation of US business income

US business income from US real property is subject to tax at the regular US tax rates applicable to US taxpayers. The tax rate schedule applicable to the foreigner's US business income will depend on whether the foreigner earning the income is an individual, corporation or trust, and the characterisation of the income as ordinary income or capital gains.

Tax rates

The maximum individual and corporate regular tax rates for 2020 are 37% and 21%, respectively. For individuals, the maximum tax rate on long-term capital gains is generally 20% or 25% to the extent of certain prior depreciation deductions. For corporations, long-term capital gains are taxed at the regular tax rate. Nevertheless, it continues to be necessary for corporations to track capital gains and losses because, generally, capital losses can be deducted only against capital gains.

The remainder of this section provides a general discussion of how the US business taxable income from US real property is determined.

No distinction is made between the US business taxable income of foreign corporations and foreign individuals, versus that of US citizens, residents and US corporations because, in determining taxable income, the same rules generally apply to each. Similar rules also apply to trusts, although some additional complexities apply that are beyond the scope of this discussion.

A partnership is not a US taxpaying entity. Instead, the partners, whether they are corporations, individuals or trusts, report their respective shares of partnership income on their US income tax returns. Under recently enacted partnership audit rules, the US IRS, will be allowed to collect taxes associated with audit adjustments for years ending after 31 December 2017 at the partnership level. These new rules effectively impose an entity-level tax on the partnership. However, if the partnership satisfies the requirements for certain exceptions, the tax may be imposed at the partner level rather than at the partnership level.

US business gross income

Generally, all US business income is reportable by foreigners in their US income tax return, in the year received if they are cash basis taxpayers, or in the year earned if they are accrual basis taxpayers.

A regular corporation, whether US or foreign, must generally use the accrual method, unless it meets certain narrow conditions.

US business gross income will generally include US rental income, income from the sales of US real property interests and miscellaneous income, such as interest income on deposits maintained in connection with the US business, or other income, such as from the sale or scrapping of equipment or other assets used in the business.

Special rules apply to US business income earned through direct investments by foreign persons in a US partnership earning US business income. Under these rules, a partnership is generally required to pay a WHT on behalf of the foreign partner equal to 21% of the net business income allocable to the foreign partner. The withholding is available to offset the foreign partner's actual tax liability to be reported on its US tax return. Foreign partners are permitted in certain cases to certify related losses and deductions incurred outside the partnership, which reduce that partner's tax. In addition, the regulations alter the 21% withholding rate to the applicable individual tax rate in the case of partners who are individuals or trust, so that the withholding rate more closely matches the actual tax rate applicable to such income.

Deductions allowed to reduce gross income

Generally, US tax rules permit deductions from gross income for ordinary and necessary business expenses, which generally include depreciation, wages and salaries, repairs and maintenance, property taxes, equipment rentals, accounting and bookkeeping fees, insurance and advertising. Cash basis taxpayers generally deduct their expenses in the year paid, while accrual basis taxpayers generally deduct them in the year to which they relate.

Inventories and uniform capitalisation rules

Special income tax rules apply to the accumulation of and accounting for costs incurred by real property dealers and developers, including the costs of land acquisition, development and construction. Dealers are persons who purchase real property for resale frequently and in the ordinary course of their trade or business. Uniform capitalisation rules require that certain indirect costs are accounted for as part of the development cost and deducted in the year the real property is sold.

Interest expense paid or incurred by real property dealers and developers is also subject to the uniform capitalisation rules.

Interest expense

Although interest expense incurred in connection with a US real property is generally deductible for US income tax purposes, a deduction may be deferred or completely denied under the following circumstances:

- Interest is subject to the uniform capitalisation rules discussed above.
- Interest owned to foreign related parties cannot be deducted until paid.
- Interest is part of a passive activity loss that is not currently deductible because of certain limitation rules.
- Interest between related parties is in excess of that charged in "arm's length" transactions.
- Interest is paid on shareholder debt of thinly capitalised corporations, and the IRS considers the debt to be equity.
- Interest is incurred on debt to carry tax-exempt investments.
- Interest is paid to a non-US entity that falls within the newly enacted hybrid payment rules.
- The earnings stripping rules, discussed below, may apply.

Depreciation

Depreciation has traditionally been one of the primary reasons why many US real estate investments generate losses for US income tax purposes. The number of years over which real property can be depreciated is 27.5 years for residential property, and 39 years for commercial property, including building improvements. Qualified leasehold improvements (generally those that benefit only a specific tenant rather than common areas) are depreciated over 15 years. The straight-line method of depreciation must be used for buildings. Personal property can be depreciated using accelerated methods and shorter lives. Land is generally not depreciable. However, certain improvements to land may be depreciated using accelerated methods.

Longer depreciable lives may be required when property is leased to tax-exempt organisations or for certain specially treated property.

Foreign investment in US real estate also includes investments in natural resource extraction, ie, mines, oil and gas wells, and farmland. Special rules can apply that permit the deduction of certain costs that otherwise are required to be capitalised.

The TCJA generally provides for immediate expensing by changing the deduction for assets eligible for bonus depreciation so that 100% of the cost of those assets can be taken in the year of acquisition. However, the percentage of a purchase eligible for immediate expensing declines for certain assets beginning in 2023 and is phased out by 2028.

The ability for real property businesses to utilise the immediate expensing will be limited. As a general matter, land and buildings are not eligible for bonus depreciation. Further, although certain improvements to the interior to non-residential real property made after an acquisition may be eligible for immediate expensing, the ability to utilise immediate expensing would not be available if the entity makes an election to treat the business as a real property business to be exempt from the interest deductibility limits.

The new bonus depreciation provisions generally are effective with respect to property acquired after 27 September 2017 and placed in service after that date.

However, the TCJA reduces the non-accelerated depreciation life of residential real property to 30 years.

Expenses paid to and transactions with related parties

A special US tax rule generally prohibits the deduction of interest and expenses, such as service fees, owed or paid to related parties before the related person to whom the payment is owed or made, reports it as taxable income. There are certain exceptions to this rule, which are beyond the scope of this discussion.

Another rule generally disallows the deduction of losses on sales and exchanges between related parties. If the sale or exchange between certain related parties results in a gain to the seller, and the property would be a depreciable asset to the related buyer, the gain, which might normally be considered a capital gain, will generally be treated as ordinary income.

The IRS also has authority to change the taxable income, gain or loss from related-party transactions if it finds that they were not carried out at prices or terms similar to those in transactions between unrelated parties. This pricing requirement is often referred to as the “arm’s length” pricing requirement for transactions between related parties.

There are other rules dictating the treatment of transactions between related parties, and the definition of related parties under the Internal Revenue Code (IRC) often varies, at least slightly, with the tax rule that is to be applied. Accordingly, before a related-party rule dictating the US tax treatment of a transaction is applied, a careful check of the applicable related-party definition should be undertaken.

Gains from the sale of the US real property

Generally, if a taxpayer sells a property, the taxable gain is the difference between the sales price, reduced by expenses of the sale, and the taxpayer’s adjusted tax basis in the property. The adjusted tax basis is normally the property’s original cost, plus improvements, less depreciation.

Gains from the sales of property by a foreigner often qualify as capital gains and, under certain circumstances discussed below, if they are not connected with a US business, they are exempt from US income tax. However, as previously mentioned, a foreigner’s gains and losses from the disposition of US real property, including the sale of stock in a US corporation having 50% or more of its assets in the form of US real property, are always treated as US business income. Note that this does not apply to any US real property interest held by a qualified foreign pension fund or any entity wholly owned by a qualified foreign pension fund (discussed further below). Foreigners selling their US real property should be aware of the instalment sales rules, the concept of original issue discount, and the rule requiring that instalment gains originating from years in which the foreigner was engaged in a US

business, be reported as US business income in subsequent years, even if the taxpayer is no longer so engaged. Another critical rule requires a 15% FIRPTA withholding tax. (see section "*Withholding tax*" below.)

Instalment sales

If a foreign investor is not a dealer in real property and at least one payment is received after the year of the sale, a proportionate amount of the gain must be reported as the payments are collected in subsequent years, unless the taxpayer elects out of the instalment method of reporting. There is an exception to this rule if certain recapture provisions apply.

Because the instalment method defers the payment of the US income tax on the gain, it has been a popular means of selling US real estate. However, the instalment method generally cannot be used by dealers of personal property, and dealers of real property for sales in the ordinary course of their trade or business. Certain exceptions can apply with respect to farm property, timeshare rights and residential lots.

An instalment note receivable with respect to which a foreign seller of US real property does not elect to report the entire sales profit and pay the FIRPTA tax in the year of the sale, constitutes a US real property interest. Accordingly, the profit element in each instalment payment received constitutes a taxable FIRPTA gain. If the seller disposes of the note, then generally the entire unreported profit becomes taxable in the year of the disposition. As a result, such foreign sellers are required to file US income tax returns to report the FIRPTA instalment gains, even if they no longer have any other business connection in the year the payments are received.

Special rules apply when instalment obligations are pledged as security for the taxpayer's debt, and when related parties are involved. In addition, an interest charge on the deferred tax may be due with respect to instalment notes totalling 5 million USD or more.

Like-kind exchanges

If certain conditions are met, US real property can be exchanged with no income tax assessed on the appreciation of the exchanged property. The TCJA limited the scope of like-kind exchanges to exchanges involving only real property. As such, real estate remains eligible for like-kind exchange treatment.

These so-called "1031 exchanges" do not have to be simultaneous, nor do only two taxpayer's need to be involved in the exchange. If an independent party, or intermediary, is properly used, the taxpayer's property can in effect be "sold" up to 180 days prior to the acquisition of the replacement property in a "deferred exchange". It is also possible, through the proper use of an accommodation titleholder, for the taxpayer to "sell" the property after the new property is acquired, in a reverse deferred exchange. The IRS issued guidance to provide a safe-harbour for taxpayers engaging in reverse deferred exchanges.

Generally, if consideration other than the like-kind properties involved in the exchange is received in the exchange, the taxpayer will be taxable on the gain to the extent of boot received. This non-qualifying exchange property could be in the form of cash, property, or debt relieved. So-called "boot netting" rules could provide tax relief when both properties in the exchange are subject to debt.

While like-kind exchanges have been preserved for real property, taxpayers exchanging real property will still need to consider the implications of any personal property transferred with real property.

The changes to like-kind exchanges generally apply to exchanges completed after 31 December 2017.

Original issue discount (OID)

If property is sold with payment of any part of the sales price deferred over six months, ie, the seller finances the purchase as an instalment sale, and an insufficient amount of interest is charged, then the original issue discount (OID) and imputed interest rules may apply. These rules reallocate the amount of interest on the deferred payments and the capital gain to be reported. Accordingly, the rules are important to foreigners selling or buying seller-financed US real property, because they could subject a foreigner to unexpected tax results. For example, imputed interest under the OID rules could be subject to the 30% US WHT.

These rules may be applicable to foreigners when either selling or buying US real property. However, certain real-estate-type transactions where privately placed debt is issued for property are exempt from the OID rules.

If the transaction does not qualify for one of the exemptions, then the OID rules will generally apply if all, or part, of the payments are due more than six months after the sale, and either the stated redemption price at maturity exceeds the instrument's stated principal amount, if it has adequately stated interest, or the stated redemption price at maturity exceeds its imputed principal amount, if the stated interest is inadequate.

The imputed interest of the debt instrument is determined by using the applicable federal rate (AFR) at the time the transaction occurs. The AFR is published monthly by the IRS and is based on the average market yield of short-term, mid-term and long-term obligations. Accordingly, the AFR will vary depending on whether the instrument is short-term, which is three years or less, mid-term, which is over three years and up to nine years or long-term, which is over nine years.

Cancellation of debt (COD) income

Generally, gross income includes income created from discharge of indebtedness. However, COD is excluded from gross income in certain circumstances including when the debt is discharged in a Title 11 Bankruptcy case, the taxpayer is insolvent, or for taxpayers other than corporations, the debt constitutes qualified real property business indebtedness (QRPBI).

To the extent COD income is excluded pursuant to these exceptions, the taxpayer must make a corresponding reduction to tax attributes such as net operating loss carryforwards, tax credit carryforwards, or the basis of property. Although this attribute reduction is generally required to be done in a specific order, taxpayers may make an election to first reduce the basis of depreciable property before reducing other tax attributes.

Non-corporate taxpayers may elect to exclude COD income resulting from the discharge of QRPBI. QRPBI is defined as debt that was incurred or assumed by the taxpayer in connection with real property used in a trade or business, is secured by such real property and was either incurred or assumed prior to 1 January 1993 or, if incurred or assumed after 1 January 1993 constitutes debt used to acquire or improve real property. To the extent COD income is excluded under the QRPBI exception, the basis of depreciable property must be correspondingly reduced. Several other potential limitations apply in determining the amount eligible for exclusion as QRPBI.

It should be noted that transfers of property in satisfaction of non-recourse debt is considered a sale transaction rather than an event resulting in COD income. In these situations, the determination of whether the debt is recourse or non-recourse is significant in determining the tax impact of the transfer.

Effective connection of deferred income

Foreigners cannot avoid US income tax by arranging to receive US business income in later years when they are no longer engaged in a US business. In such cases, the deferred income will still be reportable by, and taxable to, the foreigner, if it would have been taxable as US business income at the time the foreigner actually made the sale of the US business assets or rendered the services to which the deferred income relates. This rule applies to deferred income on instalment sales of personal property used in the US real estate business, as well as to deferred payments of US rental income.

Credits against the regular income tax on effectively connected income

There are two tax credits pertinent to real estate investments – the rehabilitation credit and the low-income housing credit. In addition, the TCJA introduced the Opportunity Zones program. The Opportunity Zone program a new incentive intended to increase investment in certain areas of the United States that fall within certain economic criteria and are designated Opportunity Zones by the respective state government.

Taxation of income not connected with a US business

US-source income of a foreigner that is not connected with a US business, such as rental income, is subject to US tax at the rate of 30%, or lower treaty rate, of the gross income. The tax is normally required to be withheld by the payer at the time of payment. This US-source income also often takes the form of interest, including original issue discount interest, dividends from US stocks, royalties and certain capital gains. No deductions for expenses are allowed against income not effectively connected with a US business. Capital gains of a foreign investor, other than from the sale of US real property interests, are generally not taxable since in most circumstances, the gain would be foreign sourced (eg, sourced to the residence of the seller). An exception to this rule applies to a foreign individual who is physically present in the US for 183 days or more during the taxable year. In such cases, US-sourced capital gains is generally taxed at the rate of 30%. Foreign individuals, ie, NRAs, who spend 183 days or more in the US during the calendar year, will generally be considered US residents for US income tax purposes for that calendar year, starting with the first day of their presence in the US. US residents, like US citizens, are taxed on all their income, both business and non-business, from all sources, both US and foreign, on a net basis. If an NRA is considered a resident alien the the 30% WHT on gross income does not apply to them all of their net capital gain is subject to US federal income tax at regular US income tax rates. There are limited instances where an NRA who is present in the United States for 183 days would nevertheless be subject to the 30% tax on capital gain (eg, the foreign investor continues to be considered an NRA by reason of an income tax treaty).

Gains from the sale of US real property interests are not subject to 30% tax, because they are always taxable under FIRPTA as US business income, irrespective of the number of days the foreigner spends in the US. Interest income earned by a foreigner on US bank deposits is also generally exempt from the 30% tax. However, as mentioned previously, if the interest qualifies as US business income, it would be subject to the regular net basis tax. US-sourced interest paid to foreigners that qualifies as portfolio interest is also exempt from the 30% tax. Generally, to qualify for this exemption, the interest must be paid on obligations issued after 18 July 1984, which meet a series of requirements to help assure it is not being paid on obligations held for the benefit of US persons.

Withholding requirement on fixed or determinable annual or periodic income paid (FDAP)

Withholding agents, whether foreign or domestic are required to withhold 30% US-sourced FDAP income.

Following are some instances where a US corporation used solely to hold a US real estate rental business might be required to withhold the 30%, or lower treaty rate, tax:

- dividends paid to the foreign shareholders;
- service fees paid to foreigners for services performed in the US;
- rents paid to foreign persons for use of property in the US; and
- interest paid to foreign persons.

Failure to withhold the tax on these payments makes the payer liable for the tax and possible penalties.

In certain instances, a foreign corporation may be treated as a withholding agent to the extent payments made by the foreign corporation are treated as US source payments under the sourcing rules.

Special rules

Portfolio interest exemption

The Tax Reform Act of 1984 eliminated the 30% US WHT imposed on foreign persons on interest qualifying as portfolio interest. The Act also exempted the portfolio interest obligations from US estate tax. Accordingly, if foreign investors, using their own money, can finance US real property and business acquisitions with portfolio interest-bearing debt, they can achieve the following tax objectives:

- The interest paid by the US real property business will be exempt from US WHT.
- The portfolio debt instruments held by the foreign investors or their entities will be exempt from US estate and gift taxes.
- The interest payments will be deductible by the US business and, therefore, will shelter the property's operating income or gain upon disposition. The deductibility of the interest payments may be limited and deferred under either the passive activity loss rules or the earnings stripping rules.

Foreign investors may find it difficult to structure internal financing to qualify for the portfolio interest exemption. The reason is that portfolio interest does not include interest received by a shareholder or partner owning directly, indirectly, or constructively, 10% or more of the voting interests in a corporation or 10% of the capital or profits of a partnership paying the interest. If the 10% ownership hurdle can be overcome, then the rest of the requirements to qualify for the exemption can be met by privately issued debt, as well as publicly issued debt, if the debt is properly structured. With respect to partnerships, the 10% ownership test is applied at the partner level.

The portfolio interest exemption will also not apply to the following:

- interest received by a bank with respect to credit extended in the ordinary course of its trade or business;
- interest received by a controlled foreign corporation from a related party; and
- interest that is contingent on the borrower's profits, receipts, cash flow, or property values.

Other general requirements and restrictions, according to the type of debt, are summarised below.

Requirements for registered form debt

Interest paid to a foreign person on registered form debt will qualify for the portfolio interest exemptions if the following general requirements are met:

- The interest payer, or its agent, receives a statement from the beneficial owner of the interest, or a bank, securities clearing organisation, or other financial institution acting as the owner's agent, that such owner is neither a US citizen nor a US resident.
- The principal and stated interest of the obligation are registered with the issuer, or its agent, and the obligation can be transferred only by the following:
  - either turning in the old instrument and reissuing it to the new holder, or by issuing to the new holder a new instrument that substitutes for the old instrument;
  - using a book entry system maintained by the issuer, or its agent; or
  - turning in and reissuing the old instrument as described above, and also using a book entry method as described above.

Registered form debt is debt that meets the second condition above, including the transferability requirements mentioned. The regulations cover what constitutes registered as to principal and interest, and what is an acceptable book entry system. The statement required of the obligation owner must be made under penalties of perjury and must also include the name and address of the beneficial owner. However, procedures exist for allowing certain financial institutions to be the registered owners of the obligations as agents for the foreign beneficial owner, so the anonymity of the owner is maintained, and the requirements are met.

Election to be taxed on the basis of net income

The 30% tax on the gross amount of non-business rents can be quite onerous, especially in the early years of a real estate investment, when the investment often produces a net loss or only a small profit. To remedy this harsh result, a foreigner holding US real property may elect to be taxed on US real estate income as if it were connected with a US business. This election – the net basis election – is available under the US IRC for individuals, as well as foreign corporations, and is not dependent on the existence of an income tax treaty. If the election is made, deductions for ordinary business expenses may be claimed by filing a US tax return. Generally, these deductions will be equal to, or greater, than the gross income from the property in the early years. Accordingly, a foreign corporation making the election may incur little or no tax if it can mitigate the BPT as a result of a treaty, or because it always reinvests its earnings in US real properties or other US businesses. The election applies until revoked. However, revocation is subject to the consent of the IRS, unless the revocation is made before the expiration of the statute of limitations for the year with respect to which the election was initially made, usually three years after the return is filed.

Limitations on the deductibility of passive activity and at-risk losses

Certain investors may be limited in their use of tax losses under the at-risk and passive loss rules. These rules are primarily aimed at preventing individuals and certain closely held and personal service corporations, whether US or foreign, from using tax shelter losses to offset income from other investments or activities.

The at-risk rules generally limit the losses that an affected taxpayer can use to the amount that the taxpayer has "at-risk" in an activity, which is generally defined to include the amount of money and the adjusted basis of property contributed by the taxpayer to the activity and certain amounts borrowed with respect to the activity. In the case of an activity of holding real property, a taxpayer is considered at risk with respect to the taxpayer's share of any qualified non-recourse financing that is secured by real property used in such activity.

The passive activity loss rules generally provide that losses from passive activities can offset only income from other passive activities, or gains from the sale or disposition of these activities.

A passive activity is any for-profit or business activity in which the taxpayer or its majority shareholders do not participate materially, ie, regularly, continuously and substantially. However, rental activities are always considered passive activities with respect to the investor, unless the investor is an individual or closely held corporation that meets strict requirements to be considered to be in a real property business. To be so considered, an individual must spend more than 750 hours per year working on real estate activities, and this time must constitute more than half of the individual's work activities. A closely held corporation is considered to be in a real property business if more than half of its gross receipts for a taxable year are derived from real property trades or businesses in which it materially participates. For this purpose, activities of the company's employees will be taken into account only if an employee owns at least 5% of the company.

A special relief provision applies to certain individual investors and permits them to offset up to 25,000 USD of non-passive activity income with losses from rental real estate under the following conditions:

- if they own at least 10% of the property;
- if they actively participate in its operation; and

- if their adjusted gross income is less than 150,000 USD.

Active participation is a less stringent requirement than material participation.

The passive activity loss of a closely held corporation, other than a personal service corporation, can offset other active business income, but the loss cannot offset portfolio investment income, ie, interest, dividends, royalties, annuities and gains from the sale of assets generating these types of income. For purposes of the passive activity loss rules, a corporation is closely held if more than 50% of the value of its outstanding stock is owned, directly or indirectly, by five or fewer individuals, even if they are not residents of the US.

Alternative minimum tax (AMT)

The alternative minimum tax (AMT) is a separate tax calculation that individuals, estates and trusts must consider if they are subject to the US regular income tax system. The AMT is not a duplicate tax. Instead, the taxpayer pays the higher of the regular income tax calculated or AMT.

The AMT is levied at the maximum rate of 28% of alternative minimum taxable income. Therefore, one significance it has, is that deductions of taxpayers in AMT-paying situations, to the extent available, result in less tax savings than under the regular tax scheme where the maximum federal rate is 37% for individuals.

Tax shelter reporting

A foreign investor who is required to file a US income tax return may be required to disclose participation in certain "reportable transactions" to the IRS or certain state tax authorities. Significant new penalties may be imposed with respect to failure to disclose, and understatements relating to, certain "reportable transactions", and the statute of limitations may be extended for certain non-disclosed transactions.

Branch level taxes

Branch-level tax (BLT)

The branch-level tax (BLT) consists of two primary and separate taxes, as follows:

- branch profits tax (BPT); and
- branch level interest tax (BLIT).

BLIT, in turn, has two parts, which are BLIT based on interest paid, and BLIT based on deductible interest in excess of the amount paid, or excess interest.

The following is a discussion of rules pertaining to BLT. Some points mentioned below were explained in the early sections regarding planning and are mentioned again because of their significance to the entire BLT scheme.

Branch profits tax (BPT)

BPT is generally 30% of the annual amount of earnings that the foreign corporation is considered to have taken out of its US business. It is imposed in addition to the regular tax, and state and local income taxes. As a result of the BPT provisions, a foreign corporation might be required to pay federal income tax amounting to 44.7% of its gain from the sale of a US real property.

BPT generally applies to foreign corporations that earn business income, or income treated like business income by virtue of a net basis election, through a US place of business, ie, a branch. For these purposes, income and gains realised by foreign corporations from US real property, excluding gains from the sale of stock in a US real property holding corporation, are treated as business income earned through a US place of business. BPT may not apply, however, to a foreign corporation that qualifies as a resident of a country that has an income tax treaty with the US that eliminates the tax.

Dividends paid by a foreign corporation whose gross income is at least 25% effectively connected with a US trade or business may be subject to a "second-tier" of US withholding at the rate of 30% (ie, FDAP).

Mechanics of BPT

The mechanics of BPT can be difficult to follow. The annual calculation of a foreign corporation's US business earnings considered repatriated for a tax year, also called the dividend equivalent amount (DEA), can be summarised as follows:

- US business earnings and profits for the tax year, plus
- net decrease in the net equity of the US business, or minus
- net increase in the net equity of the US business, equals
- dividend equivalent amount.

DEA, multiplied by the 30% BPT rate, results in the BPT payable.

BPT points to note

The foreign corporation's US business earnings and profits (E&P) are not the same as the taxable income or the net profit or loss generally shown on the financial statements or books and records of the US business. The determination of E&P, for US income tax purposes, is generally based on a different set of rules than the determination of taxable income or book income. Some of the differences are as follows:

- Depreciation, for E&P purposes, is determined using longer asset lives or cost recovery periods.
- Tax-exempt income is included as part of E&P but excluded from taxable income for regular tax purposes.
- Federal income taxes, but not BPT and BLIT, are deducted for E&P purposes, but not from taxable income for regular tax purposes.
- The deductions for losses from passive activities apparently are not limited for E&P purposes. (As discussed above under "*Limitations on the deductibility of passive activity and at-risk losses*", passive activity loss rules generally limit the amount of such losses to income from passive activities.)

Net equity of the US business, or US net equity, is generally equal to cash plus the adjusted tax basis, for E&P purposes, of those assets that generate, or are expected to generate, US business income, or income treated as US business income in case of a real property net basis election, less those liabilities related or connected to the US business.

Generally, dividends paid by a foreign corporation are not US sourced income and not subject to US WHT. In certain instances, the dividends of a foreign corporation are treated as US sourced depending on if the foreign corporation is distributing earnings arising from income effectively connected with a US trade or business. If the BPT applies to a foreign corporation in any tax year, then the US WHT on US-sourced dividends paid to foreign shareholders from E&P of such tax year will not apply, and such dividends will not reduce that year's E&P for BPT purposes. The effect of such dividends is accounted for through the upward or downward adjustments for changes in US net equity.

The BPT was not intended to apply to the repatriation of earnings from pre-1987 tax years. Dividends paid out of such E&P should be subject to the US WHT.

A foreign corporation with current-year E&P deficits, ie, losses, would appear not to be subject to a BPT. However, if US assets were repatriated during the tax year in other than a complete termination of the US business, and the company had cumulative positive E&P at the end of the tax year that accumulated since the effective date of the BPT law, BPT would apply. This occurs because, in essence, the US assets repatriated were a distribution of part or all of such cumulative E&P. This rule is analogous to the rule governing corporate distributions in loss years by domestic corporations and foreign corporations not subject to the BPT.

Conversely, E&P repatriated are assumed to be distributed first out of current year E&P. Therefore, if US assets are repatriated during the year, ie, no longer used in the US business, and there is positive E&P for the year, BPT will result, even if cumulatively the foreign corporation has E&P deficits.

A foreign corporation will not be subject to the BPT on the repatriation of its cash after it has sold all its US real estate and other US business assets if it completely terminates its interest in US business assets and does not reinvest those assets in a US trade or business within three years. This result is the same as that which would apply had the foreign investor used a US corporation to hold the US business and had liquidated the US corporation after it sold its assets.

Branch-level interest tax (BLIT)

Branch-level interest paid tax

The law treats any interest paid by a foreign corporation's US trade or business as if it were paid by a US corporation. Generally, interest paid by a US corporation to a foreign entity or person is subject to the 30% US WHT. Accordingly, the 30% US WHT will apply to interest paid by the US branch, unless a US tax treaty applies to lower or eliminate the tax.

Branch-level excess interest tax

The branch rules also impose a 30%, or lower treaty rate, tax on the excess of the interest expense deduction allocable to the foreign corporation's ECI for US tax purposes over the actual interest paid by the branch.

Allocable interest is interest that is allocable to income effectively connected, or treated as effectively connected, with the conduct of a trade or business in the US. The calculation of the allocable interest deduction for a foreign corporation with only US real property and other US businesses is relatively simple, because all interest would be related to the US business, and so would be effectively connected.

However, for corporations having businesses within and without the US, the computation of the US interest expense deduction can be complex and can result in interest deductions that exceed the amount of interest actually paid by the foreign corporation's US trade or business. Since these computations also affect a second-level tax, they are important for foreign corporations doing business within and without the US and can result in the imposition of the 30% BLIT. However, an election is available that allows foreign corporations basically to reduce their interest expense to the amount of interest actually paid, thereby eliminating the BLIT problem.

Operating rules for the BLIT

Regulations issued by the IRS reflect most of the operating rules for the BLIT.

Interest exempt from the regular 30% US WHT provisions pursuant to the IRC should also be exempt from the branch level interest paid provisions. Such exemptions include the following:

- interest earned on US bank deposits that are not connected with the foreign corporation's US business;
- interest that is not connected with the US business;
- interest qualifying for the portfolio interest exemption;
- original issue discount (OID) on obligations maturing in 183 days or less from the original date of issue.

The 30% US tax on interest paid should be withheld by the foreign corporation, and remitted to the IRS, under the normal withholding and remittance procedures, because the tax on interest paid is considered imposed on the beneficial owner of the interest.

Disclosure of treaty-based positions

Persons and entities subject to US income tax that take a position on their US income tax returns that a US treaty overrules or otherwise modifies a US tax law must disclose the position on the tax return. Regulations indicate specifically when an income tax return is required and when other filings, such as WHT returns, will satisfy these requirements.

Failure to disclose a treaty position can subject the taxpayer to a 1,000 USD IRS penalty, or 10,000 USD in the case of regular corporations.

Disclosure of related-party transactions

US corporations that are at least 25% foreign-owned, and foreign corporations that are engaged in a US trade or business, are required to report transactions with related parties to the IRS. These disclosures are made on Form 5472. There is a penalty of 10,000 USD for each failure to file this form when it is required.

FIRPTA

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) and its regulations, which subject a foreign investor to US tax on a disposition of an investment in US real property, eliminated almost all viable means for foreigners to avoid US income tax permanently on these dispositions.

The FIRPTA rules contain two separate and distinct aspects. The first is the substantive aspect, which taxes NRAs and foreign corporations on the disposition of a US real property interest (USRPI). Gain or loss realised by a foreign person from the disposition of a USRPI is automatically considered US business income, irrespective of whether the foreign person is doing business in the US. The second aspect of FIRPTA is the withholding and reporting requirements.

Taxing provisions

A USRPI includes not only a direct interest in real property located in the US or the US Virgin Islands, including any pro rata interest held through a partnership, trust or estate, but also an interest in stock in a US corporation that is a US real property holding corporation (USRPHC).

Basically, for a corporation to qualify as a USRPHC, USRPIs must constitute at least 50% of the fair market value of its assets. A corporation's fair market value generally does not include the value of assets not used or held for use in a business, although USRPIs and foreign real property are always includable. An alternative test based on 25% of book value of specified assets is also permitted by the regulations. Under the book value test, a company can presume it meets the fair market value test if it meets the book value test.

Despite the fact that a US corporation, or one treated as such, meets the 50% asset criteria for status as a USRPHC, the FIRPTA tax will not apply to the sale of shares of any class of the corporation's stock that is regularly traded on an established securities market if the seller owns, directly or indirectly, 5% (10% for REITs) or less of such class of stock. This exception for stock traded on an established securities market applies only if the 5%/10% test is satisfied at all times during the five-year period ending on the date of the disposition of the stock.

Real property

The term real property includes land and unsevered natural products of the land, eg, crops, timber, mines, wells, or other natural deposits, as well as improvements on land, including buildings, bridges, railroad tracks, pipelines, storage tanks and bins, and permanently installed telephone and television cables. Also included is certain personal property associated with the use of the real property, eg, furnishings or moveable walls. However, despite this general rule, personal property will be associated with, and therefore will also be considered real property for, FIRPTA purposes, only if the personal property is predominantly used in one or more of the following four activities:

- the exploitation of unsevered natural products from the land, such as in mining, forestry and farming activities. Equipment used to transport the products once they are severed is explicitly excluded from association with real property.
- the construction or making of improvements to the land;
- the operation of a lodging facility. A lodging facility generally includes a residential rental property, a hotel or a motel, but excludes a personal residence occupied solely by its owner, an aircraft, a vessel, a railroad car, or a facility used primarily to provide medical or convalescent services.
- the rental of furnished office and other workspaces.

US real property interests (USRPIs)

The FIRPTA rules provide that interests in US real property and in US corporations that qualify as USRPHCs that are held other than solely as a creditor will qualify as USRPIs for FIRPTA purposes, and thereby be subject to US tax upon their dispositions. The rules are broad enough to help assure that such interests in US real estate do not escape taxation. The following are examples from the regulations that will generally qualify as interests in US real property held other than as a creditor:

- fee ownership or co-ownership in US real property;
- a time-sharing interest in US real property;
- a life estate, remainder or reversionary interest in US real property;
- direct or indirect rights to share in the appreciation in the value, or in the gross or net proceeds, or profits generated by the US real property, or the US real property entity;
- a right to receive instalments or deferred payments from the sale of a USRPI, unless the seller elects not to have the instalment method of reporting apply, any gain or loss is reported in the tax year of the sale, and all tax due is timely paid;
- an option, a contract or a right of first refusal to acquire any interest in US real property, other than an interest held solely as a creditor;
- an interest as a beneficiary in a trust or estate that holds USRPIs;
- an interest in a partnership that holds US real property.

Leaseholds of US real property and options to acquire such leaseholds are also classified as USRPIs.

Qualified foreign pension fund

There is an exception to the FIRPTA regime if seller of the USRPI is either a qualified foreign pension fund (QFPF) or an entity wholly owned by a QFPF. A QFPF is defined as any trust, corporation, or other organisation or arrangement:

- which is created or organised under the law of a country other than the United States;
- which is established
  - by such country (or one or more political subdivisions thereof) to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (including self-employed individuals) or persons designated by such employees, as a result of services rendered by such employees to their employers; or
  - by one or more employers to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (including self-employed individuals) or persons designated by such employees in consideration for services rendered by such employees to such employers;
- which does not have a single participant or beneficiary with a right to more than 5% of its assets or income;
- which is subject to government regulation and with respect to which annual information about its beneficiaries is provided, or is otherwise available, to the relevant tax authorities in the country in which it is established or operates; and
- with respect to which, under the laws of the country in which it is established or operates
  - contributions to such trust, corporation, organisation, or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or arrangement or taxed at a reduced rate; or
  - taxation of any investment income of such trust, corporation, organisation or arrangement is deferred, or such income is excluded from the gross income of such entity or arrangement or is taxed at a reduced rate.

If the seller is a QFPF, or a wholly owned entity of a QFPF, the gain or loss shall not be treated as income effectively connected with a US trade or business.

Interests in REITs

A REIT is a US corporation, business trust, or other entity taxable as a corporation that elects to be taxed as a REIT. In general, shares in a REIT that predominantly holds US real property other than solely as a creditor are treated as USRPIs. As a result, before applying the exceptions noted below, gain recognised on the sale of REIT shares by a foreign shareholder is subject to FIRPTA and taxed accordingly. The exception noted previously for stock regularly traded on an established securities market applies to REIT stock if the foreign shareholder does not own more than 10% of the stock of the REIT. In addition, gain on the sale of stock in a domestically controlled REIT, where less than 50% of the value of the REIT's stock is held directly or indirectly by foreign persons during the five-year period ending on the date of disposition, is not subject to FIRPTA.

FIRPTA also applies to certain dividends paid by REITs to their foreign shareholders. An ordinary dividend distribution from a REIT to its foreign shareholder is generally subject to the 30% US WHT, unless the tax is reduced or eliminated by treaty. A REIT distribution to a foreign shareholder that is attributable to gain from the sale of a USRPI will be treated as such for purposes of FIRPTA and will generally not be eligible for reduced dividend withholding under a relevant US income tax treaty. A REIT distribution to a foreign shareholder that is attributable to gain from the sale of a USRPI will not be treated as gain from the sale of USRPI provided that the class of shares is regularly traded on a US established securities market and the foreign investor does not own more than 10% of the REIT stock at any time during the one year period prior to payment of the dividend.

Note that the FIRPTA tax does not apply to gains on sale of REIT stock and capital gains from distributions from REITs if recognised by qualified shareholders. In general, a qualified shareholder is an entity which:

- is privy to a US income tax treaty and is listed on a recognised stock exchange;
- if it is a, foreign partnership, was created or organized under foreign law as a limited partnership in a jurisdiction that has an agreement for the exchange of information with respect to taxes with the U.S and has a class of limited partnership units which is regularly traded on the New York Stock Exchange or Nasdaq Stock Market and such class of limited partnership units value is greater than 50% of the value of all the partnership units
- is a qualified collective investment vehicle; and
- maintains records of persons which own a 5% greater interest.

FIRPTA anti-avoidance rules

FIRPTA contains several technical rules relating to whether property is classified as a USRPI and what constitutes a disposition of a USRPI, thereby yielding US business income. These rules, which follow, were designed to prevent a foreign investor from using various devices to avoid US tax on the disposition of US real property.

A disposition of a USRPI, for purposes of FIRPTA, can be any transfer of a USRPI. Consequently, it is possible to trigger a taxable gain inadvertently when a USRPI is involved in a transaction that normally would not trigger a taxable gain. The general rule is that upon a transfer of a USRPI that would normally be non-taxable, because of special non-recognition provisions in the IRC, the non-recognition provisions will apply only if the foreign investor transfers the USRPI in exchange for another USRPI, and the interest would be subject to US income tax upon a subsequent disposition.

An interest in a domestic corporation, held other than solely as a creditor, will be presumed to be, and will be classified, as a USRPI, irrespective of the type of assets the corporation holds, unless the shareholder establishes, in accordance with procedures in the regulations, that the company was not a USRPHC at any time during the five-year period ending on the date of the particular disposition in question. Once classified as a USRPHC, and its stock as a USRPI, the corporation's stock will be considered a USRPI until the corporation no longer holds a USRPI, and all of the USRPIs previously held by the corporation during the foregoing period are disposed of in fully taxable transactions. Without these rules, a corporation could avoid USRPHC status within the five-year period by selling a sufficient amount of its USRPIs to reduce its US real property below 50%. In such a case, an interest in the corporation would not be considered a USRPI, and various approaches might be possible to avoid US tax upon the disposition of the remaining properties.

For purposes of determining whether a corporation is a USRPHC, assets held by a second corporation (including a foreign corporation) may be considered to be held directly by the first corporation. This provision applies only if the first corporation owns, directly or indirectly, at least 50% of the fair market value of all classes of stock of the second corporation. If the first corporation owns less than 100% of the second corporation, only a pro rata portion of each asset is considered owned by the first corporation.

A non-recognition provision will survive FIRPTA when the transferred US real property interest is exchanged for another US real property interest, which, immediately following the exchange, would be subject to US taxation upon its disposition. In addition, a transferor must comply with certain reporting requirements to qualify for non-recognition. FIRPTA generally provides that gain will be recognised by a foreign corporation upon a distribution, including a distribution in liquidation or redemption, of a USRPI to its shareholders. This rule provides for recognition of gain by the foreign corporation, except where the distributee would be subject to tax on a subsequent disposition of the property, and the basis of the USRPI to the distributee would be no greater than the basis was to the foreign corporation immediately before the distribution. This rule represents one of the primary hurdles that foreign corporations face in reorganising as US corporations to mitigate the BPT.

The tax basis of a USRPI held by a US corporation carries over to its foreign shareholders upon its distribution but is increased by any gain recognised by the distributing corporation on the distribution, and any US income tax paid by the foreign investor on such distribution. Without this provision, the foreign shareholder could obtain a step-up in the basis of the property to its full fair market value, without paying the full amount of US tax on the appreciation. This provision is not applicable to a distribution in liquidation or redemption where such distribution is considered a disposition by the foreign shareholder of the corporation's stock. In such case, the distribution is covered by other FIRPTA rules.

Other provisions

Double taxation

The law provides that, except for gain from the disposition of interests in real property located in the Virgin Islands, gain from the disposition of a USRPI is US-source income. Therefore, a foreigner disposing of such an interest will generally not obtain a US credit for foreign taxes, if any, imposed on the gain. In other words, double taxation of the gain could result if the foreign investor's country of citizenship or residence does not allow a credit, or some other form of relief, for the US taxes imposed by FIRPTA. In some cases, tax treaties will mitigate the potential double taxation.

Special election for certain foreign corporations

Under certain US treaty non-discrimination provisions, generally those of a tax treaty, but in some cases a treaty of friendship, commerce or navigation, the US may not discriminate against foreign corporations. In anticipation of claims of discrimination under these treaties, Congress provided an election to enable foreign treaty country

corporations to be treated as domestic corporations for the purposes of the FIRPTA taxing and reporting provisions. The election, referred to as the “Section 897(i) election”, is based on the underlying Tax Code Section 897(i).

The “i” election is critical for a foreign corporation that holds USRPIs with a tax basis lower than the foreign shareholder’s tax basis in the corporation’s stock, and that must reorganise into a US corporation either to avoid the BLT prospectively, or for other reasons. Without the election, such a foreign corporation generally must recognise FIRPTA gain upon the distribution of the property. The “i” election is also used to avoid withholding of the FIRPTA tax by the buyer of a USRPI from a foreign corporation.

The election provides these results because it causes the foreign corporation to be treated as a domestic corporation for purposes of the FIRPTA taxing, withholding and reporting provisions. Accordingly, those rules in FIRPTA applying exclusively to foreign corporations become inapplicable to the electing corporation. Some of those rules are the anti-avoidance rules, discussed previously, that trigger FIRPTA gain in seemingly non-taxable transactions. However, upon making an “i” election, the stock of the foreign USRPHC will be treated as the stock of a domestic USRPHC and, accordingly, as a USRPI taxable upon its disposition.

Under the regulations, a valid “i” election may be made only if the foreign corporation, as well as each person holding an interest in the corporation, eg, shareholder, on the date the election is made, signs a consent to the election and a waiver of treaty benefits and the corporation is entitled to non-discriminatory treatment under the pertinent treaty. More specifically, the law requires that tax, including accrued interest, be paid on all previous dispositions of the company’s stock within a ten-year period, even if such dispositions were non-taxable pursuant to a treaty. The regulations permit the electing corporation to retain the shareholder consents in its files rather than submit them to the IRS if certain conditions are met. Accordingly, the identities of the shareholders, or interest holders, will not necessarily be disclosed to the IRS. Nonetheless, examining IRS agents will have access to such consents if they believe it necessary to carry out an examination. Therefore, absolute shareholder anonymity cannot be assured. The regulations also require that the foreign corporation be a USRPHC, ie, have 50% or more of its assets, by value, in the form of USRPIs.

The regulations detail the manner, form and timing of making an election under IRC Section 897(i).

Withholding tax

The general rule is that any person who acquires a USRPI from a foreign person is required to withhold tax equal to 15% of the amount realised and remit the withheld amount to the IRS by the 20th day after the date of transfer. However, if the seller's maximum tax liability is less than 15% of the amount realised, a procedure is available to reduce the amount withheld by the buyer and/or remitted to the IRS.

Through a so-called withholding certificate application, the seller can request approval from the IRS of the seller’s representation of a calculation of the maximum tax liability that may be imposed on the disposition of the real property, or a statement as to why the disposition is not subject to tax.

If the withholding certificate has been filed with and approved by the IRS on the transfer date, then the buyer or transferee can withhold a reduced amount of tax in accordance with the approved withholding certificate and remit the reduced amount to the IRS.

If the withholding certificate application is pending with the IRS on the transfer date, then the buyer or transferee must withhold 15% of the proceeds but can wait to remit the withheld amount to the IRS, pending IRS action on the application. The amount withheld or a lesser amount based on the IRS determination with respect to the application must be remitted to the IRS by the 20th day after the IRS determination. Any amount withheld but not required to be remitted to the IRS would then be returned to the seller or transferor.

A foreign seller may request a refund of any amounts withheld under this provision in excess of the maximum US tax liability. The foreign seller may request the refund prior to filing a federal income tax return; however, no interest will accrue on the refund. In addition, the foreign seller must still file a US income tax return to report the gain from the sale.

Buyers that fail to carry out the tax withholding become liable for the underwithheld amount themselves if the seller fails to pay in the tax with its US return. Penalties and interest may also apply.

The 15% withholding rule can create difficulties because the regulations require that the entire amount be withheld and remitted to the IRS by the 20th day after the date of the sale, regardless of the amount actually paid by the buyer. As a result, there could be situations, such as in an instalment sale, in which not enough of the total contract price is paid in the initial year to satisfy the withholding requirement. In such cases, buyers have the choice of obtaining a withholding certificate, if they anticipated the problem in adequate time, or paying over to the IRS the required 15%, and reducing their future instalments to the seller.

The following exemptions, inter alia, relieve the purchaser from the obligation to withhold, but do not relieve the foreign seller of liability for the tax:

The seller or transferor furnishes the purchaser or transferee with a certificate to the effect that the transferor is not a foreign person.

- The buyer or transferee determines that the property acquired is not a USRPI. If the property acquired represents shares in a domestic corporation that is not publicly traded, the transferee must obtain a statement from the transferor certifying that the stock is not a USRPI. In general, this means that the corporation must not have been a USRPHC during the five-year look-back period discussed previously.
- The transferee is an individual and acquires realty for use as a residence, not necessarily a principal residence, at a price of no more than 300,000 USD.
- The transferor has made a valid IRC Section 897(i) election to be treated as a domestic corporation and furnishes an acknowledgement of the election from the IRS to the transferee.

A domestic partnership must withhold 21% (or 20% or 25% for capital gains allocable to individuals or trusts) of any amount over which the partnership has custody, and that is attributable to the disposition of a USRPI or ECI, if the amounts are includable in the income of a foreign partner.

A trustee of a domestic trust, or an executor of a domestic estate, must withhold 21% (or 20% or 25% for capital gains allocable to other individuals or trusts) of any amount over which the entity has custody, and that is attributable to the disposition of a USRPI if the amounts are includable in the income of a foreign beneficiary of the trust/estate, or the foreign grantor in the case of a grantor trust. In addition, gains from certain distributions by foreign corporations that are taxable under FIRPTA may be subject to withholding at 21% of the excess of the fair market value of the interest distributed over its adjusted basis. Return of capital distributions by a USRPHC to its foreign shareholder may be subject to a 15% WHT.

Any transferee acquiring a USRPI from a foreign person is a withholding agent, and is obligated to withhold, unless the transaction is otherwise exempt. Also, agents of the transferee or transferor may have the liability for WHT if they fail to comply with certain requirements. For example, a transferor's agent must notify the transferee if the transferor is a foreign corporation. Failure to do so may shift the withholding obligation to the agent, limited to the amount of compensation received by the agent.

US gift and estate taxation

Gift taxation

An NRA is subject to US gift tax only with respect to tangible property situated in the US. Shares of a corporation, whether foreign or US, are intangible property for gift tax purposes, even if the corporation's only asset is US real property.

Taxable gifts by an NRA are taxed cumulatively over the lifetime of the donor up to 40%. An annual exclusion permits the donor to exclude from taxable gifts the first 15,000 USD in gifts to each donee.

Estate taxation

The estate of a non-resident alien decedent is subject to US estate tax on all property – tangible and intangible – situated in the US at death. Shares of a US corporation are subject to the estate tax, whereas shares in a foreign corporation are not, irrespective of where the corporation's assets may be situated.

The estates of NRA decedents are subject to the same US estate tax rates that apply to estates of US citizens. The rate is currently up to 40%. Although the estate of a US citizen is entitled to a credit equivalent to an exemption of 11.58 million USD from US estate tax, the estate of an NRA is entitled to a credit equivalent to only a 60,000 USD exemption, assuming no treaty benefits apply. Not all people who are US residents for income tax purposes are US residents for estate and gift tax purposes. These high rates and the low exemption amount make planning for mitigating the estate tax an important aspect of tax planning for foreign investment in the US real property.

Taxable gifts are included in the estate, and can, as a result, increase the rate of tax. Credits are allowed for gift taxes paid on these gifts. The estate tax liability can also be credited, ie, reduced, by death taxes paid to states where the taxable property has a situs at date of death.

Some US states impose a separate estate tax on property located within the state.

Gift and estate tax treaties

The US has gift and estate tax treaties with several foreign countries.

Municipal tax system in the United States

Ad valorem tax

The ad valorem tax system in the US varies by state and sometimes by local jurisdiction. Within each state the local authority, is required to comply with the tax laws of the state to annually assess and collect a tax on the value of all taxable property. There is no national law regarding the ad valorem taxation of property. All property subject to ad valorem tax is appraised as of a specific date. Most states use 1 January as that date.

Land, structures and improvements to realty are generally subject to taxation. As a general rule, the fair market value of these property items is the basis to which the local taxing authorities apply the tax levy (typically expressed as a percentage of the value). The tax levies for public schools, municipal and regional governmental units are combined for ease of collection. Tax levy rates vary by locality.

The ad valorem tax laws in several states have made provision for the exemption (or a reduction of tax basis) of property that is used for agricultural purposes; owned by a charitable, religious or not-for-profit educational organisation; controls air or water pollution; has historical significance; or was deemed to be integral to the economic development of a region. These laws vary by state and require analysis for each particular circumstance.

In addition to the ad valorem on real property, most state property tax statutes provide for the taxation of tangible personal property owned by business entities. As with real property, the levy rate for taxable tangible personal property varies by locality and may even differ from the real estate levy for a particular locality. The levy is typically applied to the fair market value of the subject property, although the valuation by assessors is frequently below the true market value or purchase price of real property.

Finally, certain states impose a property tax on intangible property, such as goodwill, copyrights and exploration rights.

Realty transfer or recordation taxes

Several states have enacted a tax on the transfer of real property between persons and the recordation of deeds or mortgages on real property. In addition to direct transfers of property, some states impose a tax on transfers of a controlling interest in an entity that directly or indirectly owns property located within the states' borders. Each state and local government that imposes the tax sets its own rate of tax and basis to which that rate is applied. This information is based on authorising state laws, and local laws may be different. Furthermore, transfer of property between entities with common ownership may be excluded from taxation.

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