Real Estate Going Global
Worldwide country summaries

Tax and legal aspects of real estate investments around the globe

2018
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Real Estate Going Global Australia

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 31 December 2018.
Real Estate Tax Summary – Australia

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).

Many investments in Australian commercial property by non-residents do not require government approval. However, investment approval will be required from the Foreign Investment Review Board (FIRB) if the investor is a foreign government entity. In that case the investor is required to notify before acquiring any interest in developed commercial land, regardless of the value (A$0 threshold) and their country of origin.

Otherwise, foreign persons need to notify before acquiring an interest in developed commercial land only if the value of the interest is more than the relevant notification threshold. The general notification threshold for developed commercial land is A$266 million unless the proposed acquisition is considered to be sensitive, in which case the threshold is A$58 million.

If the foreign person is from a country which has entered into a free trade agreement with Australia, the threshold is A$1,154 million regardless of whether the land is considered sensitive.

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 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 a final 10% MIT withholding tax 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% withholding tax on the gross amount of interest paid. Certain borrowings can qualify for relief from interest withholding tax, 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 newly introduced hybrid mismatch rules. The debt/equity rules determine the nature of a financing arrangement based on its economic substance not its legal form. The new hybrid mismatch rules can prevent the deductibility of interest payments where the loan itself or one of the entities involved would otherwise 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 capital gains tax 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 – Australia**

**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 (e.g., 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 10 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.

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 varies but, as an example, for a commercial real estate acquisition in the range between A$10 million and not more than A$1 billion, the fees amount to A$27,500.

**Stamp duty**

The Australian States and Territories impose a stamp duty on a range of transactions, including the acquisition of real property (at varying rates 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 capital gains tax 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 10 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 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.

**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 withholding tax. The rate of withholding tax depends, in case of an AUT 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 a 10% MIT withholding tax 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 withholding tax is not a final tax (unlike MIT withholding tax), 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 withholding tax rules which impose a 12.5% withholding tax on the purchase of land or interests in land from non-residents (subject to a $750,000 de minimus exemption). If a non-resident disposes of the listed 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 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, i.e., 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, 10 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 (i.e., 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 withholding tax 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 a 10% MIT withholding tax 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**: 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 withholding tax to be withheld by the MIT is by reference to the place of payment. The final liability of the withholding tax 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% withholding tax 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% withholding tax 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, Stapled Structures' 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, draft legislation is now before Parliament.

This proposed new law will impact 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 proposed law will increase the withholding tax rates on certain income by excluding specific asset classes from the MIT regime. It will also apply this increased tax rate to cross staple arrangement where the same investors hold 80 per cent 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 draft legislation includes 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 (e.g., residential housing and agriculture assets);
- preventing double gearing through thin capitalisation changes;
- limiting the foreign pension fund withholding tax 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 draft law should not 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 (i.e., typically found in hotel structures) which are not generally considered a single unified business will be adversely impacted.
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Real Estate Going Global Argentina

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
**Real Estate Tax Summary – Argentina**

A foreign investor may invest in Argentine property directly or through a local corporation (*Sociedade Anónima* or SA), a local limited liability corporation (*Sociedade de Responsabilidade 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 entities1 (which will reduce to 25% for taxable years beginning on or after 1 January 2020) and a scale based rate for residents.

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

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 2020).

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.

A tax on minimum hypothetical income is applicable to legal entities and individual owner of rural real estate. This tax will not be applicable for fiscal years starting on 1 January 2019.

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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.
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.

Prior to the tax reform introduced by Law 27430 that became effective on 1 January 2018, the rules required the buyer to withhold tax on capital gain. However, in practice, taxes were not withheld on sales between non-residents because there was no legal mechanism to do so. In April 2018, the Argentine tax authorities issued Resolution No 4227-E, establishing the mechanism for paying the capital gains due by non-residents.

The tax reform now provides that the seller, and not the buyer, should be responsible for withholding the tax for transactions made since January 2018.

Non-residents are now exempt from tax on capital gains realized 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 now taxable under the tax reform provided that (i) the value of the Argentine assets exceed 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 (which will be set by regulations) are met.

A new withholding tax on dividend distributions was established. 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 2020.

The tax reform has also abolished the so-called equalization tax for profits generated in taxable years started on or after 1 January 2018. However, the equalization 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 amortization and/or cost of a possible future sale of new goods.

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

Tax on asset revaluations

The Argentine Congress approved a one-time aimed at offsetting the absence of inflation adjustment rules with an optional revaluation of assets for companies and individual entrepreneurs.

Under this revaluation tax, taxpayers are entitled to adjust their tax basis in fixed and movable assets, shares in Argentine companies and intangible assets. Assets that have been fully depreciated are excluded. The revaluation must be computed based on certain factors. An external appraisal instead of those factors can be used for real estate that is not treated as inventory, as well as for movable assets, provided that the revaluation does not exceed 1.5 times the revaluation that would have resulted had those factors been applied.

The tax is levied on the amount of the adjustment at a rate of 8% in the case of real estate (15%, if it is considered inventory); 5% for shares, if held by individuals; and 10% for other assets. The taxpayer can select which class of assets to adjust, but once the category has been selected, all of the assets included in that category have to be adjusted.

The basis adjustment is depreciable over the remaining useful life with a minimum of five years, except for basis adjustment in real estate and intangibles, where the depreciation must be made over the longer of either 10 years or 50% of the remaining useful life.

For newly acquired assets as well as those whose bases have been adjusted, taxpayers are entitled to recover their lost value by adjusting the tax basis for inflation, as inflation adjustments have been reinstated for those assets.

It is important to analyse the future saving that can be obtained by applying the asset revaluation.

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.
A recently enacted law (Law 27440) establishes 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 have to 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 tax reform introduced a detailed definition of a permanent establishment (PE). The term ‘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 with local and foreign related parties is limited to 30% of the taxpayer’s taxable income before interest, foreign exchange losses and depreciation. The taxpayer is entitled to carry forward excess non-deductible interest for five years and unutilised deduction capacity for three years.

Foreign exchange control regulations

From December 2015, the Argentine Central Bank (BCRA) and other institutes, such as the Ministry of Economy and Public Finance and the Federal Administration of Public Revenue (AFIP) among others, have been introducing important amendments to the Free Foreign Exchange Market (MLC). In this sense, regarding incoming flows of currency (as financial loans or capital contributions), the minimum permanence term for keeping in Argentina the inflow of funds was removed. Thus, resident entities can obtain access to the MLC for cancelling the principal of a financial loan in any term and non-resident investors can repatriate their investment in any term as well. Also, the requirement to place a non-interest bearing deposit equivalent to 30% of the inflow of funds (the so-called ‘Encaje’) was repealed.

Another topic that has been significantly modified, relates to the option granted to residents to form foreign assets. It should be mentioned that prior to the introduction of the new set of regulations this alternative was cancelled. Nowadays, resident individuals and corporations and local governments may access the MLC to purchase foreign currency without the prior approval of the BCRA.

As to payments of debts arising from imports of goods, all existing requirements about documentation, amount limits or specific terms for having access to the MLC to make payments abroad were removed. In line with this, the provisions related to advanced payments have also been repealed, ie, the access to the MLC for these transactions has not any special requirements anymore.

For the payment of services rendered by non-residents, the formal prior approval of the BCRA was eliminated for payments exceeding the equivalent of US$100,000 in the calendar year for debtor and when the cancellation is to be made to a related company abroad or to beneficiaries and/or accounts established in countries not considered cooperative with fiscal transparency. The obligation to register the import of service through the Advanced Services Sworn Statement (DJAS) has been abolished and all existing requirements about documentation for having access to the MLC to pay abroad were removed.

As far as exports of services is concerned, the obligation to bring in and settle the foreign currency arising from these operations is no longer in force.

The obligation of inflow and negotiation of funds arising from collections of exports of goods, advanced collections and pre-financing operations was also removed.

Besides this, there are no formal restrictions on the payment abroad of interest, dividends or profits, royalties and other commercial payments.
The Exchange Control Regime, even when it has been mitigated, by the softening of strict international trade controls and the abrogation of informal restrictions, is still in sight. 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 (e.g., 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:

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

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

(iii) 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 authorization.

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 10 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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All information used in this content, unless otherwise stated, is up to date as of 16 July 2018.
Real Estate Tax Summary – Austria

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). Please find the progressive rates in the table below.

<table>
<thead>
<tr>
<th>Income</th>
<th>Tax rate</th>
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<tbody>
<tr>
<td>€</td>
<td>%</td>
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<td>0 to 11,000</td>
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<tr>
<td>11,001 to 18,000</td>
<td>25</td>
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<tr>
<td>18,001 to 31,000</td>
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<tr>
<td>31,001 to 60,000</td>
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<tr>
<td>60,001 to 90,000</td>
<td>48</td>
</tr>
<tr>
<td>90,001 to 1,000,000</td>
<td>50</td>
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<tr>
<td>1,000,001 or more</td>
<td>55</td>
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</tbody>
</table>

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.

**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.

**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 (i.e., 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 of "suspicion of abuse". Abuse is suspected if the foreign subsidiary is taxed at a rate not exceeding 15% and if it mainly earns "passive income". Both conditions must be met to be treated as potentially "abusive". In cases of suspected abuse, the participation exemption for dividends would be replaced by a tax credit ("switch-over clause").

In July 2018, Austria introduced CFC rules for financial years beginning after 31 December 2018. Simultaneously the anti-abuse provision mentioned above is 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. There is no loss carryback available. 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.

**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, 2% for the property value between €251,000 and €400,000, and 3.5% the portion of the property value exceeding €400,000.

**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 (i.e., housing/living purposes) is taxable for VAT purposes at a rate of 10%. Rental for accommodations, such as hotel rooms, is taxable for VAT purposes at a rate of 13% (reduced to 10% from 1 November 2018 onwards).

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 (e.g., 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 (i.e., 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 (e.g., 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

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 (e.g., 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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All information used in this content, unless otherwise stated, is up to date as of 3 August 2018.
Real Estate Tax Summary – Belgium

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 29.58% (25% as from 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 immoveable withholding tax) and retributions are not tax-deductible.

With respect to tax deductions, the tax reform Law of 25 December 2017 has introduced a new limitation rule as from 2018 (the ‘basket system’). Several deductible elements (including incremental notional interest deduction, carry-forward dividends received deduction, and carried-forward tax losses) are now only deductible up to 70% after the first €1m. In other words, for those tax assets, a minimum tax base is created of 30% after the first €1m is deducted.

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.

Besides 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).

The Belgian tax reform of 25 December 2017 has introduced a limitation of the interest deductibility of the highest amount of €3m and 30% EBITDA. This limitation of deduction applies to intragroup debt as well as to third party debt. According to recent discussions at government level, the entry into force is expected to be 1 January 2019 (in line with the date as set out in the Anti-Tax Avoidance Directive).

Belgian tax law provides, subject to certain conditions and formalities, numerous withholding tax (WHT) exemptions (e.g., 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).

**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.

Since 2018, 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 €2.5m); (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 the participation or the taxation condition is not met, taxation at the normal rate will apply (29.58%, or 20.4% for SMC’s until €100,000).

If the participation condition and the taxation condition are met, but the holding period condition is not met, the capital gains on shares will lead to a taxation at the rate of 25.5% (20.4% for SMC’s until €100,000).

As from 2020, if one of the above condition is not fulfilled, capital gains will be taxed at the normal rate of 25% (20% for SMC’s until €100,000).

An SMC is a company that does not exceed more than one of the following criteria: 50 employees, a turnover of €9m and total asset value of €4.5m. These thresholds are to be evaluated on a consolidated level.
Real estate transfer tax/VAT

The acquisition of property is subject to a 10% (or 7% for individuals acquiring their first private dwelling) or 12.5% registration duty (10%/7% for real estate located in the Flemish Region, 12.5% for immoveable 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’ or in case of resale of the asset within the two years of its acquisition in certain circumstances.

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 “black list” 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.

- Landlord and tenant mutually need to agree on the option to apply VAT.

- VAT adjustment period on eligible properties is extended (from 15 years) to 25 years.

- Short-term leases of (old or new) buildings or land of maximum 6 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 final law still needs to be approved.

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 (unless in case of application of the anti-abuse measure or in case simulation would occur).
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/GVY) 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 “black list”) 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. This limitation only applies to companies that cannot be considered as small and medium-sized companies (SMC’s) as defined by article 15 of the Companies Code. As from 1 January 2020, the pro rata regime of depreciation will also be applicable for SMC’s.

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 realized upon the disposal of immovable property will be taxable at the standard corporate income tax rate of 29.58% (25% as from 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% (7% in Flemish Region for individuals acquiring the first private dwelling), depending on the location of the immoveable property, in principle calculated on the selling price (ie, the price agreed upon by the parties).

A reduced rate of 0.2% applies in case of a regular lease agreement (rental agreement). The transfer of a long lease right (which is a right in rem) is subject to a registration duty at a rate of 2% on the transfer price increased with the remaining lease instalments.

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 to impose a penalty on the purchaser and on the seller equal to the amount of the tax evaded (ie, in the Brussels-Capital Region and the Walloon Region
a total tax charge of 37.5%: 12.5% duty plus 12.5% penalty in the hands of each party; in the Flemish Region a total tax charge of 30%: 10% duty plus 10% penalty in the hands of each party).

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) when 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. As mentioned above, the Government has issued a legislative proposal on the possibility for landlords to apply VAT on certain immovable lettings (see above).

The new rules should lead to a far reaching administrative simplification and certain more complex real structures will become redundant.

In terms of VAT, this is without doubt the most important change in the real estate industry in Belgium from both an investor, landlord, broker, service provider and end user perspective. With the new regime, the cost of investing in real estate should decrease significantly as input VAT paid on construction and operating costs will in many cases become recoverable. As a result, this change will impact a.o. deals, pricing, accounting and record keeping requirements, pending investments, servicing and real estate operating models in many sectors across the board.

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.

In the case where the acquirer stops using the building in the framework of an economic activity that entitles the acquirer to deduct input VAT, within the adjustment period (15 years for buildings constructed, or acquired with VAT as of 1 January 1996), the acquirer will have to refund the deducted VAT for $\frac{x}{15}$, ie, one-fifteenth for each remaining year of the adjustment period. The adjustment period normally start the year of the first use of the building.

Such VAT adjustment will also apply on immovable works (transformation, renewals, etc). In this case, the adjustment period is five years.

**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 when a building right (right *in rem*) is granted, 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 transfers ownership of 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). In addition, a sale must be registered at the land registry (cadastre/kadaster).

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 destruction, construction, external, or substantial refurbishment 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 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 and the environmental permit (milieuvergunning) are included in one integrated environmental permit (omgevingsvergunning).

As of 1 August 2018, the socio-economic permit will also be included in the integrated environmental permit.

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 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, a ‘single permit’ (*permis unique*) is required. The ‘single permit’ incorporates both an urban 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 urban and environmental permit. Therefore, the mixed projects in the Brussels-Capital Region require for the time being two separate permits.

**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 an urban 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 urban and environmental permit. Therefore, the mixed projects in the Brussels-Capital Region require for the time being two separate permits.

**Socio-economic permit**

The socio-economic permit is required for setting up one or more retail trades with a surface area of more than 400 square meters. In order to obtain such a permit it is necessary to follow a procedure set out in the Federal Act of 13 August 2004 as altered by the Federal Act of 22 December 2009 in order to align the Belgian legislation with the European Directive 2006/123/EG.

This aforementioned Act remains applicable only in the Flemish Region. However, the Decree of 15 July 2016 concerning the integral commercial establishment policy will include the socio-economic permit in the integrated environmental permit, as of 1 August 2018.

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

In the Walloon Region, the Decree of 5 February 2015 introduced a 'commercial establishment’ permit subject to similar conditions.
**Town planning**

Each region has adopted a comprehensive set of land allocation plans. These plans are enacted at regional and municipal levels. They can cover the whole territory of a region 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 (e.g., residence, industry, services) is prescribed. The plans can also prescribe specific provisions related to the configuration (e.g., maximum height) and the activities performed in the building located within a block.

While granting a building, environmental or socio-economic permit (c.q. an integrated environmental permit), the permit delivering authority has to comply with the provisions of the land allocation plans. 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 OVAM (the Flemish Waste Management Authority) 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 annex 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 immoveable 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 taking into account 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. This new Decree will fully enter into force as of 1 January 2019.

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.

If the extract indicates that the land is presumed as potentially polluted, an orientation soil survey will be necessary. An orientation study makes it possible to verify the presence of a possible soil pollution and provides with a first description and estimation of the pollution. If no risk zone is identified, or if the threshold values are not exceeded, the soil is considered unpolluted. No further studies are required and a soil test certificate will be issued.

If the threshold values are exceeded, a characterisation study must be carried out. Its purpose is to define exactly the nature, level and extent of pollution. It may determine the timeframe in which the remediation should be carried out and provide the needed to carry out remediation work.

**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. Furthermore it is required that certain newly built, like buildings for housing, school or office purposes, must generate a certain amount of energy out of renewable energy.

Upon sale, the EPB certificate must be transferred to the new owner. Upon lease, a copy of the EPB 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 EPB certificate and provide it to the transferee before the conclusion of a sale or lease-agreement.

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 EPB 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 an EPB certificate.

Share deal – Direct tax aspects

Since 2018, 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 €2.5m); (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 the participation or the taxation condition is not met, taxation at normal rate will apply (29.58% or 20.4% until €100,000 for SMC’s).

If the participation condition and the taxation condition are met, but the holding period condition is not met, the capital gains on shares will lead to a taxation at rate of 25.5% (20.4% for SMC’s until €100,000).

As from 2020, if one of the above condition is not fulfilled, the capital gain will be taxed at the normal rate of 25% (20% for SMC's until €100,000).

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 (i.e., 14.79%) on the difference between the fair market value of the property and its tax value (i.e., 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 has increased as a result of the introduction of the new general anti-abuse measure (see above) which should always requires a 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, i.e,
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 older than ten or even fifteen years.

- The reduced VAT rate of 6% is also applicable on the demolition of a building followed by the reconstruction of a private dwelling.

- Reduced VAT rates of 6% and 12% are applicable in other specific cases (social housing).

- Immoveable work services are subject to the reverse charge mechanism in Belgium (provided certain conditions are met). As a consequence, immoveable 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 permits, environmental permits and, in some cases, a socio-economic permit. This primary step is usually very expensive and time-consuming, but will be simplified and made cheaper with the new environmental permit as from 2017 (see above). Obtaining in due time the required permits will greatly increase the value of a plot of land.

The contractor’s status

A principal/contractor can be held jointly and severally liable with his 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 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 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.

Operating real estate company

Taxation of real estate and deductions available

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. We therefore develop the Belgian tax regime for both of them under the same titles. 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%, plus 2% additional crisis contribution, i.e., 29.58% (25% as from 2020). Reduced rates are available in some cases (mostly if privately owned or 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, immoveable WHT, etc. Regional taxes – except for those listed in article 3 of the Special Communities and Regions Finance Act of 16 January 1989 (e.g., property immoveable 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 Companies Code.

However, in order to avoid double use, some items have to be deducted from the starting base (e.g., participations, treaty branch assets less treaty branch liabilities, revaluation reserves, etc).

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 2019 (financial year ending as of 31 December 2018 or later). Please note that the NID-rate should be increased by 0.5% for SMC’s.

As from 2018, the NID will be calculated based on the increase of the risk capital in the last five years (incremental NID). Excess NID (i.e., 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 as from 2018 to the ‘basket system’. According to this system, several deductible elements (including incremental NID, carry-forward dividends received deduction, and carried-forward tax losses) are now only deductible up to 70% after the first €1 million. In other words, for those tax assets, a minimum tax base is created of 30% after the first €1 million is deducted.

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 (e.g., 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, for assessment year 2019 (financial year as per 31 December 2018 or later) a 6.75% tax surcharge becomes payable at the time the taxes are finally assessed. The timely made tax prepayments can be deducted from such surcharge at a rate of 3%, 2.5%, 2%, or 1.5%, depending on whether they have been made in the first, second, third or fourth quarter of the year.

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. Please note that the assessment period of three/seven years is also applicable for the professional, moveable 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.
The Belgian tax reform of 25 December 2017 has introduced a new limitation of the interest deductibility of the highest amount of €3m and 30% EBITDA which applies not only to intragroup debt but also to third party debt. This limitation rule is expected to apply from 2019 (in line with the date as foreseen in the Anti-Abuse Directive).

The general thin cap rule will remain 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).

Besides the 5:1 thin capitalisation rule, the 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). This applies if the interest is paid upon a loan granted by a private individual holding shares of the recipient of the loan 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 withholding tax (WHT) exemptions (e.g., 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, the tax reform Law of 25 December 2017 has introduced a new limitation deduction as from 2018 (the ‘basket system’).

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 (read 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 29% plus 2% crisis contribution, ie, 29.58% (25% as from 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, 29.58% (25% as from 2020).

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 (summarized):

• 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 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, SMC's 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 immoveable property sold more than five years from its acquisition will, in principle, be exempt while capital gains realised on a built immoveable 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**

Since 2018, 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 funds (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.

• It must however have a fully paid-up share capital of at least €1.2m. Furthermore, 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 12.75% (15% as from 1 January 2020) on its latent capital gains on Belgian real estate.
and untaxed reserves. 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 (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 eligibles/in aanmerking komende beleggers) or private investors that invest at least €100,000. 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 €1.2m. 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 Companies Code, 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 realized 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.

In Belgium, most REITs have the VAT status of a mixed taxable person, performing both exempt and taxed transactions. While the exploitation, letting and disposal of real estate generally is exempt from VAT, some real estate activities, such as the letting of storage or parking spaces, or VAT leasing (ie, a leasing whereby a number of conditions would have to be met, the most important of which is that the total amount of instalments reconstitutes the construction costs), are subject to VAT. REITs cannot act as a mere property developer or a professional building constructor, so they must opt for taxation in case they intend to sell, grant, or transfer rights in rem buildings that are still new for VAT purposes under the VAT regime. The obligation to opt for taxation will generally give rise to VAT pre-financing. As a mixed taxable person, a REIT can only partially recover input VAT paid on investments.
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).

**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 (moveable 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.

### Property taxes

**Immoveable withholding tax**

For income tax purposes, a deemed rental income (the so-called *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 (*Kadaster/Cadastre*). 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 withholding tax (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) immoveable WHT. The basis for levying such surtaxes is the base immoveable 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 immoveable 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 immoveable 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 immoveable 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 immoveable 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. As from 2019, the new interest limitation deduction rule (€3m or 30% EBITDA) is however to 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). Also, corporate taxation at full rates will often result from direct sales of assets.

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. 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, 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 real estate investment fund (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 12.75% 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

2018
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All information used in this content, unless otherwise stated, is up to date as of 26 July 2018.
**Real Estate Tax Summary – Brazil**

**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 (i.e., 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 da Pessoa Jurídica, 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 gain 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 at the rate of 15%. As of 2017, gains recognised by 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 are subject to the 25% withholding tax.

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 (e.g., 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). 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 into real estate funds (Fundo de Investimento Imobiliário, or FII) or private equity funds (Fundo de Investimento em Participações, or FIP) may provide for 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.
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 USD 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 that could apply for certain tax benefits) have different options for better structuring 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.

As a result, 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; or (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 rate. Tax rates based on the monthly income are set out in the table* below (using an exchange rate of 4 Brazilian real, or BRL, to US$1).

<table>
<thead>
<tr>
<th>Taxable basis US$</th>
<th>Rate %</th>
<th>Deductible amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 475.99</td>
<td>Exempt</td>
<td>0</td>
</tr>
<tr>
<td>From 475.99 to 706.66</td>
<td>7.5</td>
<td>36</td>
</tr>
<tr>
<td>From 706.66 to 937.76</td>
<td>15</td>
<td>89</td>
</tr>
<tr>
<td>From 937.76 to 1,166</td>
<td>22.5</td>
<td>159</td>
</tr>
<tr>
<td>More than 1,166</td>
<td>27.5</td>
<td>217</td>
</tr>
</tbody>
</table>

* This table is valid for 2017.
Resident taxpayers must file an annual income tax return (on or before April 30th 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 about their assets and rights held outside Brazil, in case the total exceeds US$100,000.

Capital gains accrued by individuals on the disposal of real estate property are subject to 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 (using an exchange rate of 4 BRL to US$1):

<table>
<thead>
<tr>
<th>Taxable basis</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1,250,000</td>
<td>15</td>
</tr>
<tr>
<td>From 1,250,000 to 2,500,000</td>
<td>17.5</td>
</tr>
<tr>
<td>From 2,500,000 to 7,500,000</td>
<td>20</td>
</tr>
<tr>
<td>More than 7,500,000</td>
<td>22.5</td>
</tr>
</tbody>
</table>

* This table is valid for 2017.

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

As of 2005, the capital gain is exempt of income tax on the sale of goods and rights, when the sales price does not exceed: (i) US$5,000 (equivalent to 20,000 BRL – using an exchange rate of 4 BRL to US$1) for shares sold through the over-the-counter market; and (ii) US$8,750 (equivalent to 35,000 BRL – using an exchange rate of 4 BRL to US$1) in all other cases.

Also, the capital gains earned by resident individuals 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 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 gain 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 US$60,000 (using an exchange rate of 4 BRL to $US1). CSLL is a federal contribution levied on a similar basis, at a rate of 9% (20% for financial institutions).

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 US$19.5m (using an exchange rate of 4 BRL to US$1) per year. The Presumed Profit Method 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 and the Presumed Profit Method 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 11,638/2007 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 12,973/2014 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 calculation regime (Actual Profit Method or Presumed Profit Method) bases, the calculation of PIS and COFINS will also change.
If the entity is subject to the real profit basis, the company will be automatically subject to the payment of PIS and COFINS in accordance with 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 Presumed Profit Method, 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 a 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 withholding tax 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 gain received.

If the disposal is made by a beneficiary domiciled in a tax haven country/territory, capital gains are subject to 25% withholding tax.

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.

**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 Investment (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 4,373, for 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)
Real Estate sales/transference, carried by individuals, corporations and non-residents is subject to the Real Estate Transfer Tax (Imposto sobre Transmissão Intervivos de Bens Imóveis, 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 itself (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 upon the fair market price of the property, 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 (i.e., 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 below to the sub-section ‘Corporations’.

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 withholding tax (WHT) nor IOF.

The payment of INE will be subject to the 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.

Please note that 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 above for detailed comments on ‘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 in reference to the method of calculation of the capital gain in Brazilian currency or foreign currency registered at the Brazilian Central Bank (BACEN).

The outflow for remitting capital gains derived from investments generated through Law 4,131 (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 4,373, 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 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 in comparison with resident investors, provided the investment is carried in accordance with Resolution 4,373, 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%.
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Real Estate Going Global Bulgaria

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 1 September 2018.
Real Estate Tax Summary – Bulgaria

General

There are no legal restrictions upon foreign companies and individuals acquiring ownership 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.

After the Treaty for Accession of the Republic of Bulgaria to the European Union (hereinafter referred to as TARBEU) entered into force on 1 January 2007, Bulgaria kept the ban on 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. Although the ban was no longer effective from 1 January 2014, the legislation related to acquisition of agricultural land was amended in May 2014 and provided requirements for the natural persons to have been domiciled in Bulgaria for more than five years and for the legal entities to be registered under Bulgarian Company Law for more than five years.

The internal legislation has a different approach towards individuals and legal entities coming from any other country (non-EU and EEA countries) with relation to acquisition of land. They could acquire land (agricultural, forests, etc) if so provided under an international contract which was signed between Bulgaria and the respective country, and is ratified by Bulgarian parliament and become effective.

Rental income

Rental income is subject to general corporate income tax of 10%.

Interest expenses incurred in relation to real estate are generally tax-deductible, subject to the thin capitalisation restrictions outlined below. Companies applying IFRS determine the interest expenses eligible for capitalisation into the value of the property based on the relevant accounting standards. 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).

Thin capitalisation

Interest expenses incurred by a domestic or a foreign resident company may not be fully tax deductible if the debt/equity ratio (D/E) of the company exceeds 3:1 for the respective year. The ratio is to be determined, by taking into account the average between the amounts as of 1 January and as of 31 December of the year. However, even if the D/E test is not met, the thin capitalisation restrictions may not apply if the company has sufficient profit before interest to cover its interest expenses.

Interest under bank loans/financial leases is not restricted by the thin capitalisation rules, unless the transaction is between related parties or the respective loan/lease is guaranteed by a related party. 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.

Even if some interest expenses are disallowed under the thin capitalisation rules in the year when accounted for, they may be reversed (deducted for tax purposes) during the following five consecutive years, if there are sufficient profits.

New interest limitation rules are expected to apply as of 1 January 2019 under the EU Anti-Tax Avoidance Directive. Overall, under the published draft implementation law, net interest expenses should be deductible for tax purposes in the year when accounted for, only up to 30% of the company’s tax-adjusted EBITDA. The new regime will apply to interest costs regardless of whether incurred under related party loans or third party loans. Non-deductible interest from one year should be tax deductible in subsequent years without time limitation observing certain limits. The new regime should not apply to interest costs below a safe harbour currently set at €255,000. Any developments with the final implementation legislation should be monitored.

**Depreciation**

For tax purposes the tax-deductible depreciation is calculated in accordance with the straight-line method. The Corporate Income Tax Act prescribes for maximum annual depreciation norms, within which tax depreciation is deductible. Corporate tax depreciation maximum rates vary from 4% to 50%, depending on the nature of the asset. The maximum 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 may not be depreciated for tax purposes.
Introduction

The real estate market in Bulgaria ranked among the main FDI and GDP drivers prior the crisis attracting large investments in 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 two 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 properties and attractive yields ranging between 7.75% (office buildings) in Q2 of 2018 with expected further growth, 7.25 % (retail sector) in Q2 of 2018 with upward trend in short term, and 8.75 % (industrial properties) in Q1 of 2018, projected to stay unchanged in short term.

Legal aspects

In the course of the pre-accession negotiations with the EU, the Bulgarian State undertook the commitment to adopt and implement in its statutory 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’), referred to above, entered into force.

Now, the Constitution embeds the imperative rule that aliens or non-resident legal entities may acquire directly or through legal succession a right of 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 is in compliance with the Constitution.

Now the law generally permits the acquisition of land by nationals and legal persons from the EU Member States and EEA States. The restrictions provided in law only refer to acquisition of agricultural land. After TARBEU entered into force on 1 January 2007, 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 and provided requirements for all natural persons (including Bulgarian citizens) to have
been domiciled in Bulgaria for more than five years and for legal entities registered under Bulgarian Commercial Law for more than five years. As a result, a legal entity registered in EU Member States and EEA States is permitted to acquire lands, except for agricultural land. Agricultural land could be acquired by a legal entity which: (i) has been registered under Bulgarian Commercial Act for more than five years or (ii) if registered for less than five years, its shareholders have lived in Bulgaria for more than five years.

A natural person is entitled to acquire agricultural land if the individual has lived in Bulgaria for more than five years.

The internal legislation has a different approach to the individuals and legal entities coming from any other country (non-EU and EEA countries) with relation to acquisition of land. They could acquire land (agricultural, forests, etc) if so provided under an international contract which has been signed between Bulgaria and the respective country, and is ratified by Bulgarian parliament and become effective.

Ownership of real estate can be acquired through a purchase contract or donation, based on a contribution to a company, or on other bases stipulated by law (eg, inheritance).

Any contract transferring ownership over a real estate or establishing limited property rights over real estates (such as right to construct, right to use, etc) or mortgages must be executed in the form of a notary deed, drawn up by a notary public. Afterwards, the notary deed should be registered with the Real Estate Register kept with the respective registry office as per the location of the real estate. The registration, itself, does not concern the acquisition of the ownership right, but has the purpose to make third parties aware of the transfer of ownership over the real estate or of its encumbering with any third parties’ rights. If the notary deed has not been duly registered, it cannot be opposed to third parties who have acquired the ownership or a limited property right over the estate prior to the registration of the notary deed.

**Taxation aspects**

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

- There is a flat 10% corporate income tax.

- 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.

- Withholding tax (WHT) at 10% applies to certain income payable to non-residents (eg, interest, royalties, technical services (including consulting and management) fees, rental payments and capital gains). Dividends and shares in a liquidation surplus are subject to 5% WHT. An exemption is provided for dividends and shares in a liquidation surplus distributed to EU/EEA resident companies.
• Interest and royalty accrued to related parties established in the EU are not subject to WHT under the EU Interest and Royalty rules as implemented in the domestic legislation.

• Foreign exchange fluctuations are recognised for corporate income tax purposes.

• The real estate annual tax rate is between 0.01% and 0.45%, determined by each municipality. Likewise, the transfer tax may vary from 0.1% to 3%. Donation tax varies between 0.4% 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 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. Generally, tax depreciation of buildings, repairs and maintenance are tax-deductible, whereas the impairment and the revaluation of the assets are not recognised for tax purposes in the year when accounted for and 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 an arm’s length basis, ie, at market prices. If the price of a transaction differs from the price that would be agreed between independent persons, the domestic tax authorities may challenge the contracted price and adjust the tax base by the ascertained difference.

**Value-added tax (VAT)**

The standard VAT rate is currently 20%. There is a reduced rate of 9%, which applies for accommodation in hotels and other similar places.

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 (and the underlying area plus an adjacent area with three metre width) 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 always 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. 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 a 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.

There is no WHT on dividends payable to Bulgarian trading companies. Such dividends are non-taxable income for the receiving local company. 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 paid to non-resident lenders is generally subject to WHT at a 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 of 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

Investors coming from EU Member States and EEA States may directly acquire land (except from agricultural land), may establish a Bulgarian legal entity that will acquire the real estate directly, or acquire shares in a Bulgarian company that owns the property.

In view of the general business environment, as elsewhere in the region, 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 and tax position of the company should be examined. If necessary, the seller of the shares should be asked for certain guarantees regarding the legal and tax position of the company, although it should be remembered that the enforcement of such guarantees may not always be reliable.

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 akcii).
- Limited liability company (drujestvo s ogranichena otgovornost).
- Joint stock company (acionerno 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).

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 is 2 BGN. The minimum quota value is 1 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 can be established without a public offer and requires a minimum share capital of 50,000 BGN. The minimum share value is 1 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 (e.g., with the US, Ireland, Sweden, Ukraine) provide that the tax exemption does not apply if the capital gains are realised from the disposal of shares deriving their value from immovable property.

In case the shareholder selling the shares is a Bulgarian company, the capital gain/loss realised from the respective sale would be reflected in the assessment of the taxable profit with domestic CIT of 10%, unless the share deal is executed on a regulated market in the EU/EEA.

**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) are also due upon acquisition of property.

Generally, these taxes and fees are due from the buyer. However, the parties can agree on other arrangements. If they agree to split the taxes and fees, by law, they will be jointly and severally liable for them. 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 or as a result of a transformation of a company (e.g., in case of a merger, spin-off, etc).
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 investment companies. 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 in Bulgaria**

**Debt financing**

**Thin capitalisation rules**

According to the Bulgarian thin capitalisation rules, the interest expenses incurred by a resident company may not be fully tax deductible if the average debt/equity ratio of the company exceeds 3:1 in the respective year. However, even if the debt/equity test is not met, the thin capitalisation restrictions may not apply if the company has sufficient profit before interest to cover its interest expenses.

Interest under bank loans/financial leases are not restricted by the thin capitalisation rules, unless the transaction is between related parties or the respective loan/lease is guaranteed by a related party. Also, if the interest expenses are capitalised into the value of the property or are not recognised for tax purposes on other grounds, the thin capitalisation rules would not be relevant.

Even if some interest expenses are disallowed under the thin capitalisation rules in the year when accounted for, they may be reversed (deducted for tax purposes) during the following five consecutive years, if there are sufficient profits.

New interest limitation rules are expected to apply as of 1 January 2019 under the EU Anti-Tax Avoidance Directive. Overall, under the published draft implementation law, net interest expenses should be deductible for tax purposes in the year when accounted for, only up to 30% of the company’s tax-adjusted EBITDA. The new regime will apply to interest costs regardless of whether incurred under related party loans or third party loans. Non-deductible interest from one year should be tax deductible in subsequent years without time limitation observing certain limits. The new regime should not apply to interest costs below a safe harbour currently set at €255,000. Any developments with the final implementation legislation should be monitored.
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 related parties) without business justification or above market price level are considered as hidden distribution of profits. That can lead to adverse tax implications.

Withholding tax
As mentioned above, interest paid to non-resident lenders is subject to WHT at a rate of 10%. The rate may be reduced in accordance with the relevant DTT. Under the Interest and Royalty rules as implemented in the Bulgarian domestic legislation, interest accrued by Bulgarian companies to EU-based related entities, is not subject to Bulgarian WHT under certain conditions (eg, minimum direct shareholding of 25% for at least two years, etc).

Reporting duty
Bulgarian residents are obliged 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. Also, the status of the loan should be reported quarterly to the 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 company incorporated in Bulgaria. The registered capital can be increased either with cash or with an in-kind contribution, subject to a resolution of the company’s shareholders. Debt financing is also a practical approach used when investing in real estate (ie, receiving a loan either from a shareholder or from a third party). At a further stage the lender can contribute its receivable towards the company (as an in-kind contribution) to the company’s registered capital.

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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Real Estate
Going Global
Canada

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 19 July 2018.
**Real Estate Tax Summary – Canada**

**General**

Non-resident investors may invest in property in Canada by direct ownership of the property from offshore or through Canadian a resident corporations, partnerships, or trusts.

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 C$3,000. The portion of the expenditure in excess of C$3,000 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 5-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 objects 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 tax rate will vary depending on how the property is held, and in which of Canada’s ten provinces and three territories the property is located.

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, which will 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 a non-resident acquires the property through a Canadian corporation, the Canadian corporation will pay tax in Canada subject to the federal and provincial tax rates for that year. These rates vary depending on which provincial or territorial jurisdiction the property is held in.

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, testamentary trust, or inter vivos trust). Provincial income taxes could also be payable.

**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. However, CCA may be claimed on buildings and other structures at rates generally varying from 4% to 10%. Enhancements have been made to the CCA rates for newly constructed assets acquired after 18 March 2007, generally resulting in a 6% CCA rate for non-residential buildings.

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 which cost more than C$50,000) 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 (including 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 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. Realized 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 realized. 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 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, where the shares derive (or have derived 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, if a non-resident shareholder owns 25% or more of the issued shares of any class of the corporation during a five-year period and more than 50% of the value is derived from real property. Interests in partnerships and trusts are treated in a manner similar to shares.

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 exceed 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 carryforward

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 3 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, such as interest paid to related parties or paid or credited in respect of participating debt arrangements, dividends, rents, or royalties by Canadian residents to non-residents 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% of the property value. 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.

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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All information used in this content, unless otherwise stated, is up to date as of 23 July 2018.
Real Estate Tax and Investment Summary – China

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 some key information on investments realized by individuals.

Foreign investment control
Real Estate Industry no longer belongs to ‘Restricted Foreign Investment Industries’ in China based on the Catalogue for the Guidance of Foreign Investment Industries (revised in 2017).

Foreign investors are required to establish a real estate development Foreign Investment Enterprises (FIEs) 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. Enterprises or individuals only have a land use right (ie, leasehold) and the ownership of the property built on the land. Generally, leasehold of the land and property for common residence purpose is 70 years. For land and property for commercial use, the leasehold period is 40 years.

Corporate structure
As previously 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, a real estate development FIE can take one of the following four common forms:

**Wholly Foreign Owned Enterprise (WFOE)**

A Wholly Foreign Owned Enterprise (WFOE) may be allowed for foreign investors to engage in the non-restricted real estate projects, such as development and construction of common residences. For other restricted real estate projects, only joint venture (JV) would be allowed in the PRC at the current stage. Please note that an advanced discussion with the local PRC approval government authority in this regard is required.

Pursuant to the prevailing PRC regulations, it stipulates the following requirements for the establishment of real estate development FIEs:

- Having a minimum registered capital of 1 million 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 PRC regulations concerning the establishment of FIEs.

Nevertheless, please note that the local PRC government may set out more stringent requirements in respect of the above mentioned capital and professional staff requirements.

**Equity joint venture (EJV)**

EJV has the legal status of a limited liability enterprise, where the Chinese and foreign partners share rights and obligations, profits and losses, according to their respective proportion of registered capital contributed by each party. The relevant PRC laws have not stipulated the maximum percentage of equity interest required to be held by the foreign partner. In general practice, foreign investors usually own no less than 25% of the equity interest, but the maximum amount of foreign ownership is not specified. However, we have seen cases where the Chinese partner is a silent partner and only holds a nominal percentage of equity interest of a real estate development JV. Capital contribution in EJV may be in cash or in such kind as building, land-use-right, equipment, industrial property, etc.

**Contractual joint venture (CJV)**

A CJV can or cannot be a legal-person in China. Incorporated CJV has the legal status of a limited liability enterprise whereas unincorporated CJV does not have a legal person status. The rights and obligations, share of profits and losses, way of management and ownership of properties upon the expiry of the co-operation period should all be prescribed in the joint venture contract (JV contract). The JV contract terms would largely depend on the negotiation results of the JV partners rather than proportion of equity contributed by each party. The investment contribution by each party may be their cooperation conditions or obligations. In practice, the Chinese partners usually contribute in such kind as land or land-use-rights, natural resources, labour, equipment, buildings etc, while the foreign partners normally provide capital, advanced technology, key equipment, etc. The parties to the CJV may share the profits/losses, the revenue or the products according to the stipulations in the JV contract.
Foreign-invested partnership (FIP)
The partnership model is a relatively new form of investment in China. A FIP may be formed by two or more foreign partners or jointly by foreign partners and Chinese partners. In other words, it is acceptable that all the partners in the FIP are foreign corporations and/or foreign individuals. As a generic advantage of partnership, the FIP structure is flexible in terms of profit sharing and undertaking of liability because they can be agreed upon among partners. However, there are still various concerns that would need to be clarified in order to determine whether partnership is a suitable and effective form of real estate investment by foreign investors.

FIP provides a more flexible model for foreign venture capital and foreign private equity funds to invest in China. However, real estate industry is a restricted foreign investment industry. FIP is generally allowed in pure equity investment in property rich enterprises.

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 10% or 5% depending on the status of the taxpayer and the property starting from 1 May 2018.

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, generally, 70% of the appraised value is subject to RPT at a rate of 1.2% per annum. In some cities, such as Shanghai, it is 1.2% on 80% of the appraised value per annum.

For the rental property, rental value is subject to RPT at a 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 a rate of 0.05%. For leasing of property SD will be imposed on rental income at a rate of 0.1%. For construction contracts SD will be imposed on the construction price at a rate of 0.03%.

**Thin capitalisation rules**
The China Corporate Income Tax Law (which took 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 derived by individuals is subject to an IIT rate of 10%.

**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 the sales proceeds of property;
- 5% for the rental of non-residential property or 1.5% for the 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 a rate of 4% per annum. For individual non-residential property, rental value is subject to RPT at a rate of 12% per annum.

**Composite rate for combined individual income tax (IIT), value-added tax (VAT) and real property tax (RPT) 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, a composite rate at 5% of gross rental is applied (which includes IIT, VAT, RPT and local surcharges) for individual residential property. While for individual non-residential property, the applicable composite rate is either 3.5% or 5% in Shanghai and 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 a rate of 0.05%. For leasing of property SD will be imposed on rental income at a 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, sale of the equity invest in a real estate enterprise is outside of the charging scope of VAT.

**Corporate income tax (CIT)**
Gain on disposal of equity derived by an enterprise in China is subject to CIT at a rate of 25%. Gain on disposal of equity interest derived by a non PRC enterprise is subject to withholding income tax at a 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 documents need to be retained for a legal and qualified construction project:

- Land use right certificate
- Construction land planning permit
- Construction project planning permit
- Construction permits for construction project
- Real estate sales permit
- Certificate of the completion of the project acceptance
- Commodity residential quality guarantee
- Commodity residential use brochures
Building works

Architect
Technically speaking, foreign investment in the architectural industry is officially allowed in China. However, in practise, it is difficult to obtain the relevant qualification certificate.

Construction
Foreign enterprises are rarely involved in the construction sector. It is rather a cost competitiveness issue than a regulatory restriction.

Tax aspects

Corporate income tax (CIT)
A construction enterprise shall pay CIT on profit derived from sources inside and outside China at a rate of 25%.

Value-added tax (VAT)
Construction service income is subject to VAT at either 3% or 10% depending on the status of the construction enterprise and the status of the construction project starting from 1 May 2018.
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Real Estate Going Global Cyprus

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 1 June 2018.
Real Estate Investments – Cyprus

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 straightforward and applications are handled by the local District Administration Office in the district where the real estate is located. There are internal guidelines governing the granting of such permission. Permission is granted usually for one residential property (apartment or house) and/or one office premise or otherwise as may be approved by the Competent Authority in accordance with regulations which are from time to time in force.

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 purchase of Cyprus situated real estate.

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:
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 (i.e. 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 depreciation allowances and for costs deductible against sales proceeds realised upon potential disposal of the property.

Refer also to the ‘Special contribution for defense (SDC)’ section.

### 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. Further, balancing statements are not required in cases of tax-qualified company reorganisations.

Finally, land does not attract tax depreciation allowances.

**Capital gains on the sale of property**

Unless the seller is considered to be a trader in real estate, 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.

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 were disposed of.

The taxable gain is generally calculated as the difference between the disposal proceeds 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.

Other expenses that relate to the acquisition and disposal of immovable property are also deducted from the gain, subject to certain conditions (e.g., interest expenses on related loans, transfer fees, legal costs).

The following lifetime exemptions are available to individuals:
Real Estate Investments – Cyprus

Capital gain arising from: | Deduction €
---|---
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.*

**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 carry forward**
The tax loss incurred during a tax year and which cannot be set off against other 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.

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(ies) will not affect the eligibility for group relief as long as such company(ies) 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 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 is calculated on the market value of the property as at 1 January 1980, at the varying rates as noted in the table below, which apply 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:

<table>
<thead>
<tr>
<th>Market value</th>
<th>Rate</th>
<th>Fee</th>
<th>Accumulated fee</th>
</tr>
</thead>
<tbody>
<tr>
<td>First 85,000</td>
<td>3%</td>
<td>2,550</td>
<td>2,550</td>
</tr>
<tr>
<td>From 85,001 to 170,000</td>
<td>5%</td>
<td>4,250</td>
<td>6,800</td>
</tr>
<tr>
<td>Over 170,000</td>
<td>8%</td>
<td>83,850</td>
<td></td>
</tr>
</tbody>
</table>

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, 0.15% for values from €5,001 up to €170,000, and 0.2% for values above €170,000, subject to an overall maximum amount of stamp duty of €20,000. Exemption from stamp duty applies in the case of a qualifying reorganisation.

Special contribution for defence (SDC)

In addition to income tax (refer to 'Rental income' section) SDC is also imposed on rental income. SDC is imposed on gross rental income, reduced by 25%, at the rate of 3% (i.e. at an 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**

The supply of new buildings (before their first use as well as the land on which they are built) is subject to VAT at the standard rate of 19%.

The supply of second-hand buildings (after their first use) is exempt from VAT.

The letting of immovable property is also exempt from VAT except where it relates to the following:

- the provision of accommodation in the hotel sector or a sector of similar character;
- the letting of premises and sites for parking vehicles;
- the letting of permanently installed equipment and machinery;
- the hire of safes;
- VAT is imposed on leasing of immovable property (land and commercial buildings, other than residential buildings) when used by the lessee in making taxable supplies. The lessor has the right to opt not to impose VAT on the specific property. The option is irrevocable.
- VAT is imposed on the sale of non-developed building land, which is defined as land intended for the construction of one or more structures in the course of carrying out abusiness activity. No VAT is imposed on the purchase or sale of land located in a livestock zone or areas that are not intended for development, such as environmental protection, archaeological, and agricultural zone/areas.
- Reverse charge provisions apply on transactions relating to transfers of immovable property during the process of loan restructuring and for compulsory transfer to the lender.
- The long-term leasing of immovable property will be regarded as supply of goods for VAT purposes as of 1 September 2018.

**Imposition of the reduced rate of 5% on the acquisition and/or construction of residences for use as the primary and permanent place of residence**

The reduced rate of 5% applies to contracts that have been concluded as from 1 October 2011 onwards provided they relate to the acquisition and/or construction of residences to be used as the primary and permanent place of residence for the next ten years.

Following a legislative amendment, the restriction that existed for the imposition of the reduced rate of VAT on the first 200 square meters for private residences up to 275 square meters no longer applies.

Based on the amendment, the reduced rate of VAT of 5% applies on the first 200 square meters whereas for the remaining square meters as determined based on the building coefficient, the standard VAT rate is imposed.
The reduced rate is imposed only after obtaining a certified confirmation from the Commissioner of Taxation.

The eligible person must submit an application on a special form, issued by the Commissioner of Taxation, which will state that the house will be used as the 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 the primary and permanent place of residence. The application must be filed prior to the actual delivery of the residence to the eligible person.

As of 8 June 2012, eligible persons include residents of non-EU Member States, provided that the residence will be used as their primary and permanent place of residence in the Republic.

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 the 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 his primary and permanent place of residence before the lapse of the ten year period must notify the Commissioner of Taxation, within thirty days of ceasing to use the residence, and pay the difference resulting from the application of the reduced and the standard rate of VAT attributable to the remaining period of 10 years for which the property will not be used as the main and primary place of residence.

In addition based on the amendment, persons who have already acquired a residence on which the reduced VAT rate was imposed, can re-apply 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 residence has lapsed or not. A condition for this to apply is that in case the ten year period of using the residence as the main and permanent place of residence has not lapsed, the persons must pay back to the Tax Department the difference in the VAT between the standard and reduced VAT rates applicable at the time of the acquisition or construction of the residence.

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 exceeding twice the amount of the VAT due, or imprisonment up to three years or may be subject to both sentences.
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Real Estate
Going Global
Czech Republic

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Introduction

The real estate sector in the Czech Republic is keeping its stable growth rate in 2018. The tax environment remains stable and the pending legislative changes should not adversely affect the real estate market.

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 2018 is 19%.
- Tax losses may, in principle, be carried forward for five tax periods immediately following the tax period in which the tax loss arose.
- Certain restrictions on the ability to redeem losses apply if there is a substantial change in the ownership of a company.
- There is no carry back of losses in the Czech Republic.
- Tax losses cannot be set off against the profits of a group company.
- Dividends and interest payments are liable to 15% withholding tax (WHT) (this rate may be reduced by a double taxation treaty, if applicable). A 0% WHT applies to qualifying dividend distributions and interest payments, in accordance with the EU Parent-Subsidiary and Interest-Royalties Directives. A 35% WHT applies if the recipient is not resident of a country with which the Czech Republic has concluded an effective double tax treaty or treaty on the exchange of tax related information.
- Both realised and unrealised foreign exchange differences are subject to corporate income tax (CIT) in the tax period in which they arise.
- Real estate acquisition tax is charged at a flat rate of 4% on the transfer of ownership title to real estate.
- 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.
• Planned 30% EBITDA interest tax deductibility restriction with a 80m CZK safe harbour rule should kick-in as of 1 January 2019 with the mandatory implementation of the EU Anti-Tax Avoidance Directive (ATAD).

**Legal aspects**

Ownership of real estate can be acquired through, e.g., 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.
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 2m CZK (€80,000).
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 3 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 taxes (WHT)**

Dividends are subject to a 15% WHT. In the case of dividend payments to a recipient abroad, the relevant double taxation treaty may reduce this rate. The 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, 35% WHT applies if the dividend recipient is not resident of a country with which the Czech Republic has concluded an effective double tax treaty 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 a rate of 15%. The rate may be reduced in accordance with the relevant double taxation treaty. As of 1 May 2004, a 0% WHT applies to qualifying interest payments, as a result of the implementation of the EU Interest-Royalties Directive. However, 35% WHT applies if the interest recipient is not resident of a country with which the Czech Republic has concluded an effective double tax treaty or treaty on the exchange of tax related information.

**Value-added tax (VAT)**

VAT is charged at three rates, the standard rate of 21%, which applies to most goods and services, the first reduced rate of 15%, which in general applies to foodstuff and some other expressly listed goods and services and 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 are subject to standard VAT rate of 21% VAT; however, real estate that qualifies as ‘social housing’ is subject to the first reduced 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.

Please note that the Chamber of Deputies is currently looking at an amendment to Czech VAT Act according to which the VAT corrective adjustment will also apply on repair/maintenance costs associated with real estate asset exceeding 200,000 CZK.

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 real estate transfer tax of 4% and capital gains being subject to 19% CIT 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 double tax treaty, the gain may be outside the scope of Czech taxation. Nevertheless, in certain double tax treaties (e.g., 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 effected 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 tax treaty 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 double tax treaty 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 double tax treaty 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 a 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.
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 15% WHT. This WHT may be reduced by relevant double taxation treaty.

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
In 2018, the Ministry of Finance in the Czech Republic published the draft of amendment to Czech income tax law implementing the European Anti-Tax Avoidance Directive (ATAD). Starting from January 2019, the borrowing costs shall be deductible in a tax period in which they are incurred only up to 30% of the tax payer’s earnings before interest, tax, depreciation and amortisation.

At the same time, the tax payer may be given right to deduct borrowing costs up to 80m 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.

It is expected that thin capitalisation rules and new rules limiting tax deductibility of interest will apply simultaneously.

**Foreign exchange differences**

Unrealised foreign exchange (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 a 15% WHT. This rate may be reduced by the applicable double taxation treaty. As of 1 May 2004, a 0% WHT applies to qualifying interest payments between related parties, as a result of the implementation of the EU Interest-Royalties Directive. However, 35% withholding tax applies if the interest recipient is not resident of a country with which the Czech Republic has concluded an effective double tax treaty 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 taxes

**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
Going Global
Denmark

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 1 August 2018.
Real Estate Tax Summary – Denmark

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.

Rental income/taxable income

Public and private limited companies resident in Denmark are taxed at a 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 2.9% (for 2018) of the tax value of qualifying assets. Further, net financing expenses can only reduce the taxable income before net financial expenses by a maximum of 80%. Net financing expenses of 21.3m DKK may, however, always be deducted. A new 30% EBITDA rule will likely be introduced to replace the 80% EBIT rule as of 1 January 2019.

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 2.9% 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 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 double tax treaty or if an agreement of exchange of information is in place between Denmark and relevant country. For corporate investors it is in general always possible to have the withholding tax reduced to 22% by reclaim irrespective of a double tax treaty 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 double tax treaty 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.

There are a large number of disputes ongoing regarding the definition and application of beneficial ownership requirements, and resolution is not expected until 2019. Denmark has also introduced both treaty and directive anti-avoidance rules in 2015, but so far the case law giving guidance on interpretation is limited. The treaty override provision is likely to be replaced by a general anti avoidance rule in connection with the implementation of the ATAD directive (this should not impact the beneficial owner assessment). The arguments have been based on the fact that the recipient cannot be regarded as the beneficial owner of the interest or dividend because the recipient is considered a conduit company and has no power to dispose of the amounts received.

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.
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), and minus the value of the land).

Significant changes are expected following a real estate tax reform in Denmark, applicable from 2020. 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%).

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.

**Losses carried forward**

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 8.2m DKK (for 2018) losses carried forward may always offset taxable income.

**Real estate stamp duty/Value-added tax (VAT)**

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 1,400 DKK is charged.

Mortgage loans obtained to finance real estate are subject to a stamp duty of 1.5% subject to planning around stamp duty on existing mortgages and an additional registration fee of 1,400 DKK is charged.

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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Real Estate
Going Global
Estonia

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 19 July 2018.
Real Estate Tax Summary – Estonia

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 (aktiaselts, 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 that are located in smaller islands, 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 affected 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.

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 immovable 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 moveable 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 moveable 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, Hungary, Iceland, India, the Isle of Man, Israel, the Republic of Ireland, Italy, 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, Japan 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 tax 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 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. As of July 2018, 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 for the disposal of property with transaction values of €100,000, €1,000,000 and €10,000,000:

• €100,000 – the state fee of ca €110 and the notary fee of ca €320
• €1,000,000 – the state fee of ca €1,600 and the notary fee of ca €2,928
• €10,000,000 - the state fee is capped at €2,560 and the notary fee of ca €12,180.

Please note, however, that 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) 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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All information used in this content, unless otherwise stated, is up to date as of 23 July 2018.
Real Estate Tax Summary – Finland

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 kommandit躺htö (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 2018). 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.

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, Finland applies interest deduction limitation rules as of fiscal year 2014 onwards. Interest deduction limitations are applicable in case the total amount of net interest expenses (all interest expenses less all interest income) exceeds €500k. In such case, deductibility of net interest expenses for intra group loans is generally restricted to 25% of fiscal EBITDA. However, as the limitations are only included to the Business Income Tax Act, the limitations do not apply to companies taxed in the basket other income in accordance with the Income Tax Act. This means that the limitations do not typically apply to most real estate companies.

Please see section “Upcoming changes in tax legislation” below regarding changes to the Finnish interest deduction limitation rules arising in connection with the implementation of EU Anti-Tax Avoidance Directive.
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, e.g.,

- 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.
Real Estate Investments – Finland

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 2018). For permanent residences, the tax rate may vary between 0.41% and 0.9% (year 2018). 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 2018).

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. However, given that most real estate companies are typically taxed in the basket of other income, such companies are generally not entitled to the group contributions’ system. However, please refer to section “Upcoming changes in tax legislation” for potential change in tax legislation.

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, e.g., 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 carry forward

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 2018). 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. 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, i.e. 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 taken into account when making the adjustment liability calculations.

VAT relating to transaction costs is only deductible, if the purchaser is registered for VAT and the transaction relates to the company’s own VAT taxable business. VAT relating to supply or acquisition of shares in a real estate company is usually not deductible. VAT relating to supply or acquisition of shares in a mutual real estate company should be deductible as far as the premises are used for VAT deductible purposes and the purchaser will continue the VAT deductible use. In the light of recent ECJ and Finnish case law, the interpretation regarding the deductibility has also become increasingly stringent and the current practice is uncertain and highly dependent on the individual facts and circumstances of the case. In the tax praxis, the tax authorities have also paid more and more attention to these costs, and have challenged them in several occasions. The tax authorities have also published a guidance based on which costs that relate directly to the VAT exempt sale of real estate or shares are not deductible for VAT purposes.

**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 actualize 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 e.g., 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**

*Amendments to interest deduction limitation rules (implementation of EU Anti-Tax Avoidance Directive)*

Interest deductibility limitations will be renewed along with implementing the EU Anti-Tax Avoidance Directive I (ATAD I) in Finland as from fiscal year 2019.

On 19 January 2018, the Finnish Ministry of Finance has issued a draft of the legislative proposal to amendment to the existing interest deductibility legislation. The formal government proposal is not yet released. The main points of the draft are as follows:

- The limitations will extend to the sources of income taxed under the Income Tax Act and the Farm Income Tax Act. Therefore, the new limitations would apply also to e.g., real estate companies.
• Financing expenses will always be fully deductible if total net financing expenses (including related parties and third parties) do not exceed €500k. If net financing expenses exceed this threshold, the limitations would be applied to the total amount and not just the amount exceeding the said threshold.

• The limitation would be calculated based on adjusted taxable income and the maximum deduction allowed would be 25% of the adjusted taxable income. The adjusted taxable income would be calculated as taxable income including group contributions, adding back financing expenses and tax depreciation.

• Annual financing expenses to third parties would always be deductible up to €3m (if expenses are otherwise arm’s length and related to the company’s business).

• The restrictions on deductibility of interest will be applied to all interest expenses, i.e. interest payable to both related and third parties. The restrictions will also extend to all expenses related to obtaining financing.

• The current exemption related to comparing the equity ratio of the Finnish taxpayer to the group ratio would be abolished.

• As is currently the case, non-deductible financing expenses will carry forward without an expiry date and ownership changes will have no effect on carry forwards.

Reform of allocation of income baskets
The Ministry of Finance has published a memorandum concerning a reform of allocation of income baskets in June 2017. The main purpose of the reform is to combine business income and other income baskets of entities. At this stage, it seems that the reform is intended to take effect in the beginning of 2020 at the earliest.

As planned, the Finnish Business Income Tax Act (BITA) would be applied to all tax payers carrying out business or professional activities. The general definition of business income would be extended to include real estate business activities. In addition BITA would be applied to all entities, excluding public bodies, religious organisations, housing companies, mutual real estate companies (MREC) and non-profit organisations, even if their activities do not meet the conditions of business activities. In practice, more companies would be taxed in the basket of business income.

A new class of asset, i.e. deemed investment asset, is intended to be created within the basket of business income. According to the memorandum deemed investment assets would be more loosely connected to the business activity than other business assets, e.g., assets currently belonging to other income basket. Treatment of capital losses would depend on classification of the asset.

Real estate taxation
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 2020.
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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018
Real Estate Tax Summary – France

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 simplifiée (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 (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 is 33.33%. This rate will progressively be reduced to 25% by 2022, as follows:

- in 2018: profits up to €500,000 are subject to corporate income tax at the rate of 28%. Profits exceeding this threshold remain subject to the standard corporate income tax rate of 33.33%;
- in 2019: profits up to €500,000 will be subject to corporate income tax at the rate of 28%. Profits exceeding this threshold will be subject to a corporate income tax at the rate of 31%;
- in 2020: all profits will be subject to corporate income tax at the rate of 28%;
- in 2021: all profits will be subject to corporate income tax at the rate of 26.5%; and
- in 2022: all profits will be subject to corporate income tax at the rate of 25%.

Social surcharge
Companies with an annual turnover of at least €7,630,000 and whose corporate income tax liability (standard rate and the reduced rate) exceeds €763,000 are subject to a social surcharge of 3.3% levied on the part of the corporate tax which exceeds €763,000.

Thus, the resulting effective rate will be: 34.43% in 2018, 32.02% in 2019, 28.92% in 2020, 27.37% in 2021, and 25.83% in 2022.
**Exceptional CIT surtaxes**

Following the retroactive repeal of the 3% contribution on dividends distributed on 6 October 2017, two exceptional corporate income tax surtaxes have been introduced. These surtaxes apply only for fiscal years ending between 31 December 2017 and 30 December 2018, and only to companies with a French turnover exceeding €1 billion. This threshold applies at the level of the company, or, for a tax-consolidated group, at the level of the group. Turnover realised outside France is not taken into account. The surtaxes are as follows:

- 15% of the corporate income tax due for the fiscal year (before offsetting of any tax credits) for companies with a turnover exceeding €1 billion (a smoothing mechanism applies if a turnover is between €1 billion and €1.1 billion); and

- an additional 15% of the corporate income tax due for companies with a turnover of at least €3 billion (a smoothing mechanism applies if the turnover is between €3 billion and €3.1 billion). The global rate of surtaxes applicable to companies with a turnover exceeding €3.1 billion will thus be 30% of the corporate income tax due, leading to a global corporate income tax rate of \[33.33\% \times 1.3\] = 43.33% (excluding the social surcharge on corporate income tax).

The exceptional surtaxes are not deductible for corporate income tax purposes.

**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.

**Barrier on deductibility of financial expenses**

Article 23 of the Finance Act for 2013 introduced a new cap on interest expense deductions for companies subject to corporate income tax in France. Companies with a net interest expense over €3m are subject to a limitation on their full interest expense, capping the deductibility at 75% of the interest for financial years opening as from 1 January 2014. The term ‘net finance expenses’ is defined as the total amount of finance expenses incurred as a consideration for financing granted to the company, reduced by the finance income received by the company in consideration for financing granted by the company.

Specific barrier rules apply to a tax consolidation.
Anti-hybrid rule

Article 22 of the Finance Act for 2014 added a new interest limitation rule (‘anti-hybrid financing rule’) for interest paid by a French enterprise subject to corporate income tax to a related French enterprise or non-resident related enterprise.

Under this new rule, deduction of interest expenses paid to related parties is disallowed in the event such expenses are subject to a low (or nil) corporate income tax rate in the hands of the lender.

The French borrower must, therefore, demonstrate that the interest income is included in the taxable result of the lender and is subject to corporate tax rate which is at least 25% of the French corporate income tax rate determined in the ordinary conditions (meaning circa 11.19% in 2018, 8.01% in 2019, 7.23% in 2020, 6.84% in 2021 and 6.46% in 2022.). This rule applies regardless of the country of establishment of the lender.

Thin capitalisation rules

Related party loans fall within the scope of the French thin capitalisation rules. Since 1 January 2011, related party loans also include loans granted by a third party (e.g., a bank), whereby repayment is guaranteed by a related party.

First, the interest rate levied on a loan granted by a related party should not exceed the annual average effective rates used by financial institutions for variable-interest loans to enterprises for an initial term of more than two years (1.53% for the first semester of the fiscal year (FY) 2018 except where the company is in a position to evidence that the interest rate retained is a market rate). Otherwise, the excess interest would not be tax-deductible and would be treated as a deemed dividend.

Secondly, the interest charge should only be tax-deductible if:

- the related party indebtedness of the company does not exceed 1.5 times the level of its net equity at closing or opening; or
- if the interest charge does not exceed 25% of the operating profit before tax, before depreciation charges, before interest paid to related parties, and before part of the financial leasing charges; or
- if the borrowing entity receives interest from related parties for an amount higher than those paid to related parties.
- The portion of interest exceeding the highest of these three thresholds is not tax-deductible during the relevant fiscal year except when this portion is less than €150,000.

It should be noted that there is a safe harbour provision whereby thin cap rules should not apply if a French borrowing entity demonstrates that the overall debt-to-equity ratio (D/E) of the group to which it belongs (including foreign parent and foreign subsidiaries) is higher or equal to its own overall D/E.

Specific thin capitalisation rules apply to a tax consolidation.
According to the new rules set forth by article 12 of the Finance Bill for 2011, when interest is paid on a third party’s financing and a guarantee for the repayment of that financing is provided either by a related party or by a party whose commitment is itself secured by another company (which is also related to the borrowing entity), then the portion of interest that is payable on the secured part of the financing is treated as interest paid to a related party and, therefore, subject to the thin capitalisation limits of article 212 of the French Tax Code.

When repayment of the loan is secured by a personal guarantee, the portion of interest that would be reclassified as related-party interest would correspond to the amount of interest paid in relation to the secured portion of the third-party debt.

When repayment of the loan is secured by a guarantee in rem, the same principle would apply, except that the portion of the loan that is guaranteed would be determined according to the following ratio: value of the asset at the date on which the security has been constituted against the initial amount of the financing. Accordingly, the interest payable in relation to this secured portion of the third-party debt would be reclassified as related-party interest for thin cap purposes.

The term ‘guarantee’ is not defined. As a result, any kind of guarantee is covered, whether personal guarantees or guarantees in rem (for instance, mortgage on a property).

The new provisions do not apply in various situations (e.g., if the financing takes the form of a bond issued by way of a public offering or under equivalent foreign regulations; if the loan is guaranteed by a related party solely by way of a pledge of shares against the borrowing entity; if the loan has been obtained in connection with the acquisition of shares or its refinancing; if the loan has been taken out by ‘sociétés civiles de construction-vente’ (SCCVs) with a guarantee given by their partners limited to the level of the partners’ equity in the capital of the SCCV, etc).

The EU Anti-Tax Avoidance Directive

On January 28, 2016, the EU Commission (EC) presented its Anti-Tax Avoidance Package (ATAP). The ATAP consists of seven parts, including a legislative proposal for an Anti-Tax Avoidance Directive (ATAD).

The interest limitation rule restricts, in principle, deduction of “exceeding borrowing costs” to 30% of the taxpayer’s EBITDA, optionally with a €3m threshold.

A grandfathering clause that will end at the latest on 1 January 2024 was agreed for national targeted rules which are “as effective as the fixed ratio rules” to be applied for a full fiscal year following the publication date of an OECD agreement on a minimum standard.

These rules should be applicable as from 1 January 2019, however, if the Member State has a similar rule it can request the European Commission to postpone the transposition of this by 1 January 2024. France has requested this possibility and is still waiting for an answer.
Depreciation

Each component of a property must be booked individually and depreciated accordingly, i.e., 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 (e.g., 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 corporate income tax rate of 33.33% (34.43% in 2018, 32.02% in 2019, 28.92% in 2020, 27.37% in 2021, and 25.83% in 2022, including surtaxes payable by French tax residents only).

However, capital gains realised upon the sale of listed real estate shares is taxed at a reduced corporate tax rate of 19% where the shares are held for at least two years.

In addition, foreign entities and bodies are subject to a 33.33% capital gain tax (31% in 2019, 28% in 2020, 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. A 19% WHT can apply when listed shares are sold. The 33.33% and 19% WHT can be offset against the corporate tax due on the capital gains. If the amount of the WHT exceeds the corporate income tax charge, the excess is then refundable.

3% 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 1 January.

Under certain conditions, automatic exemptions (e.g., 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 new guidelines issued in October 2016 by the French tax authorities\(^1\), entities filing 3% tax returns must, if requested, provide the French tax authorities 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 French tax authorities have retained the right to ask for additional documentation.

**Withholding tax/dividends**

Subject to tax treaty provisions, a 30% WHT (progressively reduced to 28% in 2020, 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 corporate income tax.

Subject to tax treaty provisions, a 30% 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, 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 a rate of 75% when the dividend are paid in a non-cooperative country.

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\(^1\) BOI-PAT-TPC-20-20-20161005 n°570
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 a rate of 20%, 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 a 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.

As of 1 March 2010, VAT rules applicable to real estate transactions have been amended. In substance, the VAT regime applicable to real estate transactions is now driven by the seller, whereas the transfer duty regime is driven by the purchaser.

Surtax on real estate capital gains

As of 1 January 2013, a new tax applies to real estate capital gains (unless a sale agreement has been signed and has acquired a definite date before 7 December 2012) 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.

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) to 6% (if the amount of the capital gains exceeds €260,000). This surtax rate applies to the full amount of the taxable capital gains. Hence, the taxation rate, currently 19%, will be between 20% 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 – France

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 longer any 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 Treasury within a reasonably short period following the purchase or sale of a direct investment.

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 €1.5m a statistical form must be filed with the French Treasury 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
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 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**

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, so as to avoid creating a co-ownership, which is not particularly well adapted for such properties. This is particularly true of mixed-use complexes: 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 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. 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.

**Leasehold**

There are two categories of leasehold: construction leases (‘bail à construction’) and other long leases (bail emphythéotique). As they confer on a tenant a real estate interest, mortgages may be taken over the leasehold right.

Both leases are granted for a period 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 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 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 duty of disclosure as set out under article 1112-1 of the French Civil Code: a party 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, “one who, without an authorization, makes use of or discloses, some confidential information obtained on the occasion of the negotiations will be held liable as provided by the ordinary law of liability” (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 the French law).

A party may be liable if the party brings negotiations to an end abruptly 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 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 exchanged.

In and around Paris, 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).

In the South of France, notably, an agreement of sale (promesse synallagmatique de vente/contrat de vente) is favoured.

**The unilateral commitment of sale: Option**

In the unilateral commitment of sale (promesse unilatérale de vente), the owner undertakes to sell their 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. 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 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.
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 purge 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. In this case, the buyer has to enquire with the proper authority whether it intends to exercise its right, by sending to it a declaration of intent to dispose of the property (déclaration d’intention d’aliéner, or DIA) stating the price and conditions of the sale. The municipality may not respond (waiver of its right), accept the proposed price, or make a counter-offer.

  – **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 permits, licences or consents, which the buyer may require. The following are frequently encountered:

• a demolition permit;

• a building permit is 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 a CDEC licence, required to create new retail premises with a sales floor area that is over 300 square metres (or 1,000 square metres in certain cases), or to change one retail category into another if the sales floor exceeds 2,000 square metres as well as to create hotels with over 50 bedrooms (or 30 rooms, if outside the Paris region) or cinemas with seating for more than 1,500 people;

• a licence (known as an ‘agrément’), required to build, rebuild, 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 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 she/he sells his/her 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.

_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 Registrar’s 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 to €6,500 : 3.945% ;
• from €6,500 to €17,000: 1.627% ;
• from €17,000 to €60,000: 1.085% ; and
• over €60,000: 0.814%.

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 €80,000.

_Land registrar’s fee_

A land registrar’s 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 now totally disconnected as the registration duty liability depends solely on the intention expressed by the buyer (ie, intention to resell/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 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 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 French tax authorities 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 new 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 French tax authorities 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 French tax authorities would charge interest for late payment at 0.40% per month (ie, 4.8% 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 a 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 take a commitment to resell the property within five years after the acquisition; or only €125 if the purchaser take 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: “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 double tax treaties (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. It should enter into effect in 2019 or 2020 (1 January 2019 for some DTTs and later for others).

**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 30% 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 corporate income tax, 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.
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 less 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 corporate income tax is 33.33%. This rate will progressively be reduced to 25% by 2022, as follows:

- in 2018: profits up to €500,000 are subject to corporate income tax at the rate of 28%. Profits exceeding this threshold remain subject to the standard corporate income tax rate of 33.33%;
- in 2019: profits up to €500,000 will be subject to corporate income tax at the rate of 28%. Profits exceeding this threshold will be subject to a corporate income tax at the rate of 31%;
- in 2020: all profits will be subject to corporate income tax at the rate of 28%;
- in 2021: all profits will be subject to corporate income tax at the rate of 26.5%; and
- in 2022: all profits will be subject to corporate income tax at the rate of 25%.

The standard rate of 33.33% is increased by a 3.3% corporate tax surcharge that applies for companies with an annual turnover of at least €7,630,000 and whose corporate income tax liability (standard rate and the reduced rate) exceeds €763,000 are subject to a social surcharge of 3.3% levied on the part of the corporate tax which exceeds €763,000.

Thus, the resulting effective rate will be: 34.43% in 2018, 32.02% in 2019, 28.92% in 2020, 27.37% in 2021, and 25.83% in 2022.

Moreover, the standard rate of 33.33% is increased by another surcharge. Indeed, following the retroactive repeal of the 3% contribution on dividends distributed on 6 October 2017, two exceptional corporate income tax surtaxes have been introduced. These surtaxes apply only for the fiscal year ending between 31 December 2017 and 30 December 2018, and only to companies with a French turnover exceeding €1 billion. This threshold applies at the level of the company, or, for a tax-consolidated group, at the level of the group. Turnover realised outside France is not taken into account. The surtaxes are as follows:
• 15% of the corporate income tax due for the fiscal year (before offsetting of any tax credits) for companies with a turnover exceeding €1 billion (a smoothing mechanism applies if the turnover is between €1 billion and €1.1 billion); and

• an additional 15% of the corporate income tax due for companies with a turnover of at least €3 billion (a smoothing mechanism applies if the turnover is between €3 billion and €3.1 billion). The global rate of surtaxes applicable to companies with a turnover exceeding €3.1 billion will thus be 30% of the corporate income tax due, leading to a global corporate income tax rate of $[33.33\% \times 1.3] = 43.33\%$ (excluding the social surcharge on corporate income tax).

The exceptional surtaxes are not deductible for corporate income tax purposes.

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 (the standard withholding tax (WHT) rate being 12.8%).

**Personal income tax**

Where a taxpayer holds a property directly or through a tax transparent company, such as an SNC or SC, the taxable rental income corresponds to the cashed rental income less deductible expenses paid.

The net rental income received by a non-resident is subject to rates ranging from 0% to 45% (for income received in 2012). 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%.

Capital gains are subject to a flat rate of tax (see section above). Until 2013, the flat rate tax was final. With effect from 1 January 2013 up to 31 December 2017, the flat rate tax is merely an advance payment for the income tax assessed under the progressive rate system, any excess is refundable.

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 tax) 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

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2 Basically, dividends paid by SPPICAV can benefit from this flat tax but not revenue paid by a FPI or a SCPI.
an advance payment, any excess being refundable. The option is made on a yearly basis and is irrevocable for the tax year concerned.

**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 an SA, SAS or SARL, or unlimited liability companies, typically a ‘société civile immobilière’ (SCI) or an SNC.

In addition to a full audit of the company itself and as in the case of a direct purchase of the real estate, a full audit 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 a 0.1% transfer duty for the transfer of shares in listed or unlisted companies limited by shares. In practice, listed companies rarely are subject to the 0.1% transfer duty.
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 used by the company to acquire the real estate property.
- 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, the worst 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 benefits 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 and the Construction and Housing Code regulate building
works.

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.

Other than in many rural communities, a local municipality (or several municipalities together) will usually prepare a local land use plan (‘plan local d’urbanisme’) 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 permit**

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) 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.
\begin{itemize}
\item A licence (commonly called a ‘CDEC 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. A licence is also required to create hotels with over 50 bedrooms (or 30 bedrooms, if outside the Paris region) and cinemas with seating for more than 1,500 people.

\item 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 and which are over a certain size.

\item A discretionary consent is required to convert residential premises to offices or any other use.
\end{itemize}

**Environment law**

This area used to be governed largely by private rights between individuals. 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’, and these are the subject of a prior authorisation or declaration depending on how serious a risk the installation may be.

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 restrict development in the mountains and along the coast.

The vendor will be required to produce a report from a licensed firm, showing 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 réserves (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.

**Employer’s insurance**

The employer is required by law to take out insurance, for the benefit of themself 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 defects 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 make good 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, an employer 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 employer 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**

Value-added tax (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 ten-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 deductable against corporate tax, ie, a maximum 34.43% 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 to €407.64 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.

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 ‘privilège’. 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 ‘privilège’ is a charge over the real estate in the same way as a mortgage, save that the ‘privilège’ takes effect retroactively from the date on which the deed of conveyance is executed. The ‘privilège’ 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.

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, 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: €1 to be paid-up on incorporation.
- SCI or SNC: no legal minimum.

French company law also requires certain companies, such as an 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 (i.e., 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 with regard to the means through which a French company may manage its indebtedness.

However, the French tax authorities 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 in a position 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 (e.g., 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, thin capitalisation rules apply.

Barrier on deductibility of financial expenses

As developed above, a new cap on interest expense deductions for companies subject to CIT in France. Companies with net interest expenses over €3m are subject to a limitation on their full interest expense, capping the deductibility at 75% of the interest for financial years opening as from 1 January 2014.

Anti-hybrid rule

As developed above, deduction of interest expenses paid to related parties is disallowed in the event such expenses are subject to a low (or nil) corporate income tax rate in the hands of the lender.

The French borrower must therefore demonstrate that the interest income is included in the taxable result of the lender and is subject to corporate tax rate which is at least 25% of the French corporate income tax rate determined in the ordinary conditions (meaning circa 11.19% in 2018, 8.01% in 2019, 7.23% in 2020, 6.84% in 2021, and 6.46% in 2022). This rule applies regardless of the country of establishment of the lender.

Thin capitalisation rules

The thin capitalisation rules apply for the computation of the tax results of all the companies subject to corporate income tax and, according to the French tax authorities (FTA) Guidelines dated 31 December 2007, tax transparent entities owned by companies subject to corporate income tax, French PEs of foreign entities.

Foreign entities owning French real estate are also subject to these rules when computing their taxable income.

The tax deductibility of the interest paid on loans granted by related parties is subject to following limits:

First limit: Interest rate limitation

The interest paid to related parties is limited to the highest of:

• interest computed on the basis of the average yearly interest rate granted by credit institutions to companies for medium-term loans of more than two years (e.g., 1.53% for the first semester of FY2018);
• interest rate that the borrower could have obtained from an independent bank under similar conditions.

**Second limit: Debt-to-equity ratio**
Tax deductibility of interest charge is denied when the interest exceeds cumulatively all of the three following limits during the same financial year:

• interest relating to financing of any kind granted by related parties paid in excess of 150% of the net equity of the borrower. This limit is to be estimated (to the convenience of the borrower) either at the beginning or at the closing of each relevant fiscal year. Interpretative guidelines from the FTA allow the borrowing entity to use the share capital (fully paid up) when it is higher than the net equity;

• interest expenses exceeding 25% of the current result before tax, before interest owed to related parties, before amortisation allowances and before a portion of financial leasing charges;

• interest received by the borrower in connection with financing granted by the borrower to related parties.

The portion of interest exceeding the highest of these three thresholds is not deductible during the relevant fiscal year except when this portion is lower than €150,000.

Furthermore, under a safe harbour provision, thin cap rules should not apply if a French borrowing entity demonstrates that the overall debt-to-equity ratio of the group to which it belongs (including foreign parent and foreign subsidiaries) is higher.

Specific thin cap rules apply to tax consolidation.

In addition, when interest is paid on a third party’s financing, and a guarantee for the repayment of that financing is provided either by a related party, or by a party whose commitment is itself secured by another company (which is also related to the borrowing entity), then the proportion of interest that is payable on the secured part of the financing is treated as interest paid to a related party and, therefore, subject to the thin capitalisation limits of article 212 of the French Tax Code.

When repayment of the loan is secured by a personal guarantee, the portion of interest that would be reclassified as related-party interest would correspond to the amount of interest paid in relation to the secured portion of the third-party debt.

When repayment of the loan is secured by a guarantee *in rem*, the same principle would apply, except that the portion of the loan which is guaranteed would be determined according to the following ratio: value of the asset at the date on which the security has been constituted against the initial amount of the financing. Accordingly, the interest payable in relation to this secured portion of the third-party debt would be reclassified as related-party interest for thin cap purposes.

The term ‘guarantee’ is not defined. As a result, any kind of guarantee is covered, whether personal guarantees or guarantees *in rem* (for instance, mortgage on a property).
However, the new provisions provide some exceptions where although the financing is guaranteed by related parties, thin capitalisation rules do not apply. This would notably be the case if:

- the financing takes the form of a bond issued by way of a public offering or under equivalent foreign regulations;
- the loan is guaranteed by a related party solely by way of a pledge of shares against the borrowing entity;
- the loan has been obtained in connection with the acquisition of shares or its refinancing; or
- the loan is obtained in the context of a refinancing to allow the debtor to complete the mandatory repayment of a pre-existing debt, which is required as a result of a direct or indirect takeover of the debtor. This exclusion should allow the refinancing of secondary LBOs without the refinanced loans falling within the scope of the new provisions.

**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 terms ‘non-cooperative States or Territories’ refers, under French tax law, to any state or country which does not comply with international measures against tax fraud and tax evasion. The list published by the French tax authorities of the ‘non-cooperative States or Territories’ as of 8 April 2016 includes: Guatemala, Brunei, Nauru, Marshall Island, Niue, Botswana and Panama.

Lastly, the French Government informed that the EU list could be added to the French list.

**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 a final 12.8% withholding tax. 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 French tax authorities 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 French tax Code.

**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 a managing 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 ‘préfecture’. This card mentions the permitted activities of the holder and is delivered by the administration, 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. 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 ‘préfecture’ 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.

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. She/he 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**
It is usually provided that the rent is indexed annually. The index chosen by the parties must either be the INSEE cost of construction index (ICC), which is usually the one chosen, or an index that is in relation to the activity of one of the parties, failing which the indexation clause is void. The parties may also choose the new commercial rents index (ILC, composite index published quarterly by the INSEE), which has been implemented by a Decree dated 4 November 2008. 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.
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 to take into account the variation of the cost of construction index published quarterly by INSEE (national institution of economic statistics) 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 and theatres will often fall into this category);
- leases with a term of more than 9 years or entered into less than 9 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 huissier (bailiff), 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 are governed by the Civil Code and also by article 57A 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. There have been a number of attempts to introduce new measures, but so far these have been abandoned.

**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 fiscal year 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 €1m. In this case and for the portion that exceeds €1m, companies are entitled to use tax losses to shelter only 50% of taxable profits (ie, corporate income tax 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 less 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-VAT-able 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 French tax authorities admit that the structure can be depreciated on the basis of 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 a société en nom collectif, 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 on the basis of 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) less 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 and carried forward over six years.

**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 levied annually, for assets owned on 1 January, on the fair market value of the real estate property located in France.

Please be advised that according to new guidelines issued in October 2016 by the French tax authorities, CBRE European Industrial Fund FGR and its direct and indirect subsidiaries must, if requested, provide the French tax authorities 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;

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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 French tax authorities have retained the right to ask for additional documentation.

Exemptions
The 3% 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 double tax treaty (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 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 15 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 15 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 French tax authorities has 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% tax either spontaneously or upon request, without incurring the risk of having to pay the tax.

**Net wealth tax**

Article 31 of the 2018 finance bill removed the wealth tax (ISF) in place in France since 1982, and replaces it with a tax on real estate property (IFI) as from 1 January 2018.

The IFI will be based on real estate property which is not attributed to the professional activity of the owner.

The relevant date (1st January), the threshold for taxation (€1,300,000), the tax brackets and the definition of taxpayers subject to the tax remain unchanged compared to the rules applicable to the ISF. Similarly, the flat 30% reduction applicable to the value of a principal residence is maintained.

The five-year exclusion of assets located outside of France from the taxable base for new French tax residents called ‘impatriates’ is maintained; similarly to individual taxpayers with a tax domicile outside of France, 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 the property located in France, until 31st December of the fifth year following the year of arrival in France.

The applicable range and the taxable base for the IFI are significantly reduced; only non-professional real estate property is taxable, leading to the exemption of financial assets (notably cash, stock and equity) and moveable assets. In parallel, the rules regarding the exemption of professional assets are redefined and re-centered on real estate. New provisions have been created for deductible debts:

Regarding the debt which may be deducted for French wealth tax purposes, debts granted to an intermediary entity should be deducted from the basis for determination of the portion of the shares of the intermediary entity subject to French wealth tax. However, loan granted by the taxpayer, a member of his family or an entity controlled by the taxpayer to the intermediary entity holding the property may not be deducted from the computation of the portion of the shares subject to French wealth tax except if the taxpayer may demonstrate that the financing by debt is not mainly tax driven.

When the taxpayer has been granted a loan that may be fully reimbursed at the end of the time of the loan, the debt is deductible for French wealth tax purposes only for the annual portion of the loan that remain to reimburse. If the loan has no maturity, the debt is deductible for 1/20 of its amount each year for French wealth tax purposes.
Regarding the loans that are deductible for French wealth tax purposes, there is a limit of deduction when the taxable asset (the value of French real estate) exceeds €5m. Indeed, in such a case, when 60% of the value of the real estate is financed by debt, only 50% of the portion of the debt in excess of such threshold is deductible for French wealth tax purposes.

**Business licence tax**

As of 1 January 2010, the existing business tax has been replaced by the so-called ‘Cotisation Economique Territoriale’ (CET). CET will consist 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 CET will impact real estate investors who rent unfurnished properties in France as this type of activity was so far kept outside the scope of business tax as it did not constitute a professional activity for these purposes.

The main changes are as follows:

- Under the new provisions, renting unfurnished real estate (excluding residential property) expressly falls into the category of a professional activity and hence within the scope of the new business tax. Before 2010, where a property was rented out, the rental value of the real estate was assessed to business tax in the hands of the tenant who undertakes the professional activity in the property.

- The CFE will be due by the tenant on the same basis as before and therefore the landlord will not be subject to CFE.

- What is new is that CVAE will now 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.

The CVAE rate has a progressive rate, which will go from 0.5% for turnover of €500,000 up to 1.5% for turnover exceeding €50m.

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. The percentage of revenues and expenses earned in relation to the rental activity and taken into account in order to calculate the value added will be reduced to 10% in 2010, 20% in 2011, 30% in 2012, increasing to 90% in 2018.

**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 €4.86 to €17.08 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 €1.95 to €7.53 per square meter (commercial premises under 2,500 square metres are exempt from this tax). For warehouses, the amount of tax varies from district to district from €0.99 to €3.89 per square metres (commercial premises under 5,000 square metres are exempt from this tax).

The tax on ownership of office premises are not deductible from corporate income tax purposes.

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.

The various investigations sought by the buyer will be made during an audit and preparatory stage. During this stage, the 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.

The precautions for the seller will mainly be implemented through warranties 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). These declarations and representations would not apply if the seller sells shares of the company that owns the property.

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 one-third WHT.

The one-third WHT must be paid when the notarised deed of conveyance is filed at the Land Registry and the French tax authorities. 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 a one-third WHT.

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 French tax authorities.
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 33.33% capital gain tax (progressively reduced to 31% in 2019, 28% in 2020, 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 5 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 one-third capital gain tax except when the seller is located in a non-cooperative State or territory (Guatemala, Brunei, Nauru, Marshall Island, Niue, Botswana and Panama) 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), 50.5% (33.33+17.2), or 92.2% (75+17.2);
• As of 1 January 2013, a surtax on real estate capital gains greater than €50,000 on sales property applies to non-resident individuals so that the effective taxation rate will be:
  
  – between 36.5% and 40.5% if the seller is an EU tax resident;
  
  – between 50.8% and 54.8% if the seller is a non-EU tax resident;
  
  – between 92.5% and 96.5% if the seller is located in a non-cooperative Country.

This surtax does not apply to capital gains benefitting from an exemption as property held 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 corporate tax 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 corporate tax 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 corporate tax rate or at the reduced tax rate of 19% if the seller has held a 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-REAL 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 €15m 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/CE dated 21 April 2004, can, together with their subsidiaries (subject to corporate income tax) held at more than 95%, elect for the regime provided for by article 208 C of the French Tax Code, whereby, said companies are exempt of corporate income tax 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, a 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 60% 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 2017, there were around 26 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 parent company EU Directive. Therefore, non-French shareholders may be subject to a 30% WHT at source on the dividends received (said rate may be reduced by the relevant treaties).

• Because the companies that elect for this tax regime cease to be fully subject to corporate income tax, 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’). In other words, the SIIC regime is now available to French subsidiaries that fulfil the requirements to elect for the SIIC regime, subject to corporate income tax, 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 corporate income tax (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 a 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)**

The French Government has introduced under French law a new 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 have a 50% maximum indebtedness. Moreover, SPPICAV may not exceed a 9% maximum investment in real estate listed companies and may benefit from a corporate income tax exemption available if 85% of rental income and 50% of capital gains are distributed.

Actually, 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 corporate income tax.

Dividend distributions from SPPICAVs are not subject to the new 3% tax on dividends.

Distributions from SPPICAV to French individuals are treated as dividends. They are subject to a 21% WHT upon their payment to the French individual. Then, the dividends are subject to personal income tax at progressive rates (of up to 45%) accrued by 17.2% of social contributions and the French individual is entitled to use the 21% WHT as a tax credit against its personal income tax liability. 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 to personal income tax at progressive rates (of up to 45%) accrued by 17.2% of social contributions.

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% of social contributions.
Non-residents are subject to WHTs on dividends (30% for the entities and 12.8% for individuals), and capital gains (33.33% subject to the application of DDTs but no WHT applies on interest).

Retail FPIs benefit from a 3% tax exemption.

Furthermore, the transfer of OPCI’s shares is exempted from registration taxes, except in certain cases where a 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’s 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 existing business tax has been replaced by the so-called ‘Cotisation Economique Territoriale’ (CET). CET will consist 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 CET will impact real estate investors who rent out unfurnished properties in France as this type of activity was so far kept outside the scope of business tax as it did not constitute a professional activity for these purposes.

What is new is that the CVAE will now 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.

The CVAE has a progressive rate going from 0.5% for turnover of €500,000 up to 1.5% for turnover exceeding €50m. 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.
The percentage of revenues and expenses earned in relation to the rental activity and taken into account in order to calculate the CVAE will be reduced to 10% in 2010, 20% in 2011 and to 30% in 2012, increasing to 90% in 2018.

**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 (€/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 corporate income tax 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 (€/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 immovable 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 optimise the investment.

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.
- the ways of avoiding 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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All information used in this content, unless otherwise stated, is up to date as of 30 June 2018.
**Real Estate Tax Summary – Germany**

**Resident and non-resident status**

German tax law distinguishes between resident and non-resident status. A German resident entity is, in principle, subject to tax on its worldwide income (so-called 'unlimited tax liability'). A non-resident is subject to tax on German-source income (so-called 'limited tax liability') unless exemption from German tax is provided under the terms of a tax treaty concluded between the country of residence and Germany. The international tax treaties concluded by Germany give Germany in principle the right to tax income derived from German real estate.

**Direct or indirect ownership**

It is possible for a non-resident of Germany to make a direct investment in German real estate or an indirect investment (through an interposed acquisition vehicle). The acquisition vehicle in the latter case may be either a German resident or non-resident entity. A German resident entity is one that has either its seat or place of management in Germany. An indirect investment may be through a newly formed entity established for this purpose or by the acquisition of an existing entity, which owns German real estate.

**Applicable German tax rates**

**Corporate income tax**

The rate of corporate income tax payable by a German resident entity and by a non-resident entity is identical, namely 15% (plus 5.5% solidarity surcharge = 15.825%).

**Withholding tax**

Business income distributed by a German resident corporate entity in the form of dividends is in principle subject to a 25% withholding tax (WHT) (plus solidarity surcharge adding up to 26.375%). A reduced rate of 15% is available for non-resident corporations under further substance requirements. Many of Germany’s tax treaties provide for a reduced tax rate, and distributions that are made to a corporate shareholder resident within the European Community are exempt from WHT under the Parent-Subsidiary Directive, provided certain conditions are satisfied.

If the income received by a non-resident investor is business income generated through the activities of a German permanent establishment (PE), or rental income received by a non-resident direct investor in German real estate, German WHT is not imposed.

**Trade tax**

Trade tax (the revenue from which flows to German municipalities) is imposed on business income generated by the activities of a German PE. The rates generally vary between 12.6% and 20.3%, depending on the factor determined by the local municipality in which the business operations are carried out.
The effective combined corporate income tax and trade tax rate varies between about 23% and 34%.

**Taxable income**

**Corporate income tax**

In the course of determination of taxable income for corporate income tax purposes, a taxpayer may deduct expenses incurred in connection with the acquisition and ownership of real property as well as operating expenses, unless they are to be capitalised. Buildings can generally be depreciated straight-line at a rate of 2% or 3%.

The deduction of interest expense may for tax purposes be restricted by the ‘interest barrier rule’ (‘Zinsschranke’). They apply not only to shareholder loans but also to bank and other loans. In principle, net interest expense may only be deducted up to a maximum of 30% of the taxable EBITDA. However, exceptions are available where net interest expense is less than €3m annually, the company does not belong to a consolidation group or the company can prove that its equity ratio is not lower than the equity ratio of the consolidated group to which it belongs.

**Trade tax**

The starting point for the determination of the taxable income for trade tax purposes is the taxable income as determined for corporate income tax purposes. A number of trade tax-specific adjustments are to be made. These adjustments include an add-back of 25% of interest expense on loans and of 12.5% of rental expense for immoveable fixed assets.

Of particular interest in the case of real estate companies is a provision that permits taxpayers who are engaged exclusively in the administration of their own real estate to exclude such income from their trade tax base, reducing the taxable income to zero. This deduction, referred to as the ‘extended trade tax deduction’, is not available if additional ancillary activities or rental of fixtures ‘taint’ the nature of the income. In practice, careful planning is usually required.

**Capital gains**

For companies capital gains derived from the sale of real estate are in principal taxable at standard tax rates.

**Losses**

For (corporate) income tax purposes, losses incurred by a taxpayer may be carried back and offset against taxable income of the preceding year (with a current loss carryback limit of €1m). Alternatively, they may be carried forward without time restriction; however, loss utilisation in any one year is restricted as follows: Loss carryforwards may be used to offset profits of a subsequent year unrestrictedly up to an amount of €1m; only 60% of the taxable income in excess of €1m may be offset, however. For trade tax purposes, a loss carryback is not permitted; for loss carryforwards, the same rules apply as for income tax purposes.
Real estate transfer tax

Real estate transfer tax (RETT) is triggered when German real estate is sold to a new owner (asset deal). Furthermore, RETT can be triggered in case of direct or indirect sale of shares in German real estate owning entities, namely when

- 95% or more of the interest in the assets of a partnership are directly or indirectly transferred to new shareholders within a five-year period (interest deal); or

- 95% or more of the shares or the economic participation in a partnership or corporation are directly or indirectly unified in one hand (interest deal and share deal)

For asset deals the purchase price paid for the real estate is the assessment basis for RETT. For interest and share deals the value of the underlying property is assessed. The general tax rate is 3.5% (applicable for real estate in Bavaria and Saxony). Differing tax rates apply in most federal States. A tax rate of 4.5% applies for real estate located in Hamburg. A tax rate of 5.0% applies for real estate located in Baden-Württemberg, Bremen, Mecklenburg-Western Pomerania, Lower Saxony, Rhineland-Palatinate, Saxony-Anhalt. A tax rate of 6.0% applies for real estate located in Berlin and Hesse. For real estate located in Brandenburg, North Rhine-Westphalia, Saarland, Thuringia and Schleswig-Holstein the applicable RETT rate is 6.5%. These tax rates are amended by the federal states on a frequent basis. For updates please click [here](#).

Value-added tax

The acquisition of real estate via asset deal can qualify from a value-added tax (VAT) perspective as (i) non-taxable transfer of going concern (ii) tax exempt transfer of a single asset, or (iii) taxable transfer of a single asset at 19% if the parties opt for VAT. The rent is subject to VAT at 19% if the parties opt for VAT in the lease agreement. This option is only available insofar as the property is let to an entrepreneur who uses the property for VATable turnovers.
Real Estate Investments – Germany

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)’, i.e., to both (or either of) corporations and partnerships.

Understanding the basic tax principles

The taxable income derived from real property in Germany is determined in accordance with the provisions of German tax law, irrespective of whether the owner is a private individual or corporate body, resident or non-resident.

According to the German Income Tax Act (Einkommensteuergesetz, or EStG), non-resident taxpayers are, in general, liable to German tax only on their German-source income, including the income from real property in Germany. (For this reason, they are referred to as having a ‘limited tax liability’.) The international tax treaties concluded by Germany give the right to tax income derived from such real property to Germany (see also article 6 of the OECD Model Convention).

Indirect tax regimes, such as the VAT and the RETT (Grunderwerbsteuer), apply to transactions involving or related to German real property.

The following (non-exhaustive) section is to provide an overview on the most important taxes in connection with an investment in German real estate.

Income tax

Resident companies

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 on their level under the Income Tax Act or Corporate Income Tax Act. However, a partnership is a taxable entity for trade tax purposes.

Legal entities, in particular corporations, which have their seat or place of management in Germany, are referred to as having an ‘unlimited tax liability’ in Germany, i.e., their worldwide income falls within the scope of the German Corporate Income Tax Act.

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 (the taxation aspects of rental income are discussed below).

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).

However, if any of the partnership's activities are viewed as business in nature, all of the income will be deemed to be ‘business income’. 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 accruals 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, not only with respect to shareholder loans but also to bank and other loans (see section below ‘Interest capping rules’).

For corporations, the starting point to determine 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. With the exception of 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 acquisition or construction cost.

For buildings, the depreciation rates range from 2% to 3%, assuming a useful life of 33 to 50 years. 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.

Capital gains derived from the sale of real estate are, in general, taxable at the standard tax rates if they are classified as ordinary business income, trading in real estate, or the real estate is sold within ten years after purchase.

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’, 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 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.

Gains realised by a partner on the sale of an asset that they hold as a sole proprietor or as a special business asset may be offset against the cost of reinvestment objects acquired by the partnership to the extent the partner participates in the partnership. In addition, rollover relief is permitted for capital gains realised by sole proprietors or partnerships on the sale of shares in a corporation (limited to capital gains of €500,000 if a reinvestment is made in corporate shareholdings or tangible assets within a period of two years, or in real property within a period of four years).

The corporate income tax rate is 15%. An additional 5.5% solidarity surcharge is levied (adding up to 15.825%) on the assessed income or corporate income tax, respectively, payable.

Tax prepayments are required to be made at quarterly intervals throughout the year. Tax returns have to be filed annually, generally not later than five months after the accounting year-end or, if prepared by a professional tax adviser, by end of the year following the accounting year-end. The tax will then be assessed by the authorities based on the information provided in the tax return and will become payable at the latest one month after the tax assessment is issued.

The statute of limitations period is four years, and it commences to run from the end of the calendar year in which the tax return has been filed with the tax authorities, or 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 expiry of the limitation period, the tax assessed cannot be altered, rectified or rescinded.

For income tax purposes, losses suffered by companies (also through participations in transparent partnerships) may either be carried back for one year (maximum limit of €1m), or carried forward without time limit, however, with the following restriction: While the first €1m 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 €1m is subject to tax.)

To prevent trading in the shares of companies with tax loss carryforwards the utilisation of losses carried forward in case of changes in the ownership structure is restricted. The utilisation of tax loss carryforwards is restricted, not only for a direct, but also for an indirect change of shareholders. The restriction depends on the percentage of share capital or voting rights transferred within a five-year period to one acquirer or person(s) closely related to the acquirer or a group of acquirers as follows:

- A direct or indirect transfer (or equivalent transaction) of up to 25% has no impact on the utilisation of tax loss carryforwards.
- A direct or indirect transfer (or equivalent transaction) of more than 50% results in a complete forfeiture of the tax loss carryforwards existing at the date of share transfer (or equivalent transaction).

The rules apply to both corporate tax and trade tax loss carryforwards for transfers that take place after 31 December 2007.
According to the German Corporate Income Tax Act there is a further restriction in case of a direct or indirect transfer (or equivalent transaction) of more than 25%, but not more than 50% results in a pro rata forfeiture of the tax loss carryforwards existing at the date of share transfer (or equivalent transaction). However, the Federal Fiscal Court declared that this part of the loss forfeiture rule is unconstitutional and bounds the legislator to rearrange the loss forfeiture rule for corporations for share transfers between 25% and 50%. The draft bill for the Annual Tax Act 2018 is to amend the respective regulation regarding the harmful transfer of 25% - 50% of the shares such that loss forfeiture rules due to the change of ownership between 25% and 50% are disapplied for periods before 1 January 2016.

The disapplication solely relates to partial loss forfeiture of 25% - 50%. Full loss forfeiture remains applicable in case of share transfers of more than 50% at present. A corresponding lawsuit is still pending at the Federal Constitutional Court.

Exceptions are available:

• in the case of internal restructuring of a group 100% held by a single shareholder;

• to the extent the loss carryforwards do not exceed hidden reserves in the transferred company’s net assets.

Furthermore, it is possible to apply for relief from the forfeiture of tax losses after a harmful change in ownership, 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, cessation of the business operation, starting an additional business operation, 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. The new rule applies for transfers that take place after 31 December 2015.

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.

Further anti-avoidance rules exist for so-called ‘tax deferral models’ (Steuerstundungsmodelle), stipulating that losses from such investments may only be
offset against future profits from the same investment. These rules are particularly aiming at funds investing in the media, movie, or new energy (eg, wind parks) sectors.

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. Accordingly, the maximum loss that may be offset in any one year is restricted to €1m plus 60% of the amount by which the taxable income for the year exceeds €1m.

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. In addition to the additional corporation tax and trade tax payable by the subsidiary, dividend WHT (standard rate 25% plus 5.5% solidarity surcharge) may be assessed on the shareholder.

There are detailed transfer-pricing documentation obligations that will have to be observed to avoid the assumption of hidden profit distributions as well as the imposition of penalties for failure to comply. More specifically, failure to produce the necessary records in a satisfactory manner within 60 days (in the case of a transaction not in the ordinary course of business, within 30 days) upon request by the tax authorities may trigger the following sanctions, in addition to a correction of the taxable income:

- refutable presumption that the income was underreported, entitling the tax authorities to estimate the income at the less favourable end of a price range;
- penalties in the amount of 5% to 10% of the additional income; and
- penalties for belated production of documents.

**Non-resident companies**

Income derived by non-resident corporations from German real estate transactions is generally subject to taxation under the German Income Tax Act. Basically, the same income determination rules apply as for resident companies. The corporate income tax 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.

Taxpayers are generally allowed to keep electronic books and records in another European Union (EU)/European Economic Area (EEA) country with a regular information exchange with Germany (EU, Iceland and Norway). To obtain
the necessary approval by the tax office, certain conditions, basically relating to a proper assessment procedure, are to be fulfilled.

Resident individuals
Under the German Income Tax Act, individuals who have their residence in Germany or are physically present in Germany for more than 183 days in the tax (calendar) year are subject to so-called ‘unlimited tax liability’, ie, they are taxable on their worldwide income.

A German resident individual who receives income from real property is deemed to generate ‘rental income’ unless they carry out a business activity and the real property is attributable to their business undertaking. The net rental income derived from the property is subject to German income tax. The German Income Tax Act provides for 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.

The depreciation rules described above also apply to real property owned by individuals.

The taxation of gains realised on the sale of real property depends on the tax classification of the income derived. If the property does not form part of a business, gains on its sale are subject to income tax at normal tax rates if the sale is made: (i) before it has been acquired, or (ii) within ten years after the date of acquisition. If the sale is not concluded within the aforementioned timeframe (ie, if a ten-year holding period is observed), capital gains are tax-exempt unless the real property forms part of a business.

Non-resident individuals
Individuals who are not resident in Germany are subject to so-called ‘limited tax liability’, ie, they are taxable only on their German-source income. The determination of the tax base itself does not differ in principle from that in the case of non-resident companies described above.

Definitive WHT regime (Abgeltungsteuer)
Since 2009, a new definitive WHT regime (Abgeltungsteuer) applies to certain private investment income and capital gains such as interest paid on profit participating loans, interest paid by banks and dividends, and capital gains on the disposal of shares. The WHT rate is generally 25% flat 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. Taxpayers are taxed at their regular rates on interest income if interest payer and interest recipient are related parties. The interest received from deposits placed as collateral for the finance of an investment (in at least 10% of the shares) is taxed at full rates if these transactions meet the ‘back-to-back’ criterion.

The WHT regime provides for further exceptions from the flat tax, particularly for individuals holding 25% or more of the shares in a corporation, or for employees. Rental proceeds or capital gains from the disposal of private real property do not benefit from the 25% flat tax.

With respect to real estate investment fund income, the flat tax rules generally apply to distributions and deemed distributed income which arise to German individuals.
investors out of proceeds received by investment funds. The flat rate may in this respect be beneficial in particular for high-net-worth individuals since it covers not only dividend income, interest income and capital gains on the disposal of shares, but also rental income received from German real estate as well as capital gains on the disposal of German real estate, which has been held for less than ten years. If held for more than ten years, such capital gains are tax-free.

Individual taxpayers enjoy a savers’ exemption amount of €801 p.a. (€1,602 for married couples). Losses from capital investments may not be set-off against income from any other type of income. Partnership type real estate funds are not subject to flat rate tax. Their partners are taxed at ordinary rates.

Dividend income and capital gains of sole proprietorships and individually held partnerships that rank as business income are taxed at ordinary rates, but 40% of such income is tax-exempt and 60% of the related expenses are tax-deductible. Such business investment income includes by definition the disposal of shares in which the taxpayer holds or has held at least 1% at any time over the last five years.

**Trade tax**

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 subject to deemed trade tax.

The character of the trade tax is that of an additional (corporate) income tax. The effective trade tax rate ranges from 12.6% to 20.3%, depending on the multiplier levied by the relevant municipality. 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, based on the taxable income calculated for (corporate) income tax purposes, adjusted by certain add-backs and deductions.

The following addbacks 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). A threshold of €100,000 applies in this respect.

On the other hand, 1.2% of the unitary tax value (Einheitswert) of real property belonging to the business assets and not being 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 unitary tax value is calculated on a valuation basis as of 1 January 1964 (in the territory of the former West Germany) or 1 January 1935 (in the territory of the former East Germany) and is considerably lower than the fair market value. The deductions
therefore usually cannot compensate the addbacks, which may lead to a significant tax burden.

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 on the sale of a partnership interest (or part of a partnership interest) are subject to trade tax at partnership level.

**Extended trade tax deduction (Erweiterte Gewerbesteuer-Kürzung)**

Even if a taxpayer's activities are, in principle, regarded as subject to trade tax, 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 Gewerbesteuer-Kürzung*). 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-saving 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 disposal of a property that had been contributed on a tax-neutral basis to the company in question 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**

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. So-called ‘business fixtures’ (*Betriebsvorrichtungen*) are not viewed as real property. By contrast, hereditary building rights (*Erbbaurechte*), for details see section below ‘Managing German real estate’, and buildings erected on land owned by a third party are also deemed to be real property for RETT purposes.

In purchase agreements, it is German market practice that the purchaser will assume the RETT burden. Regardless, both parties are legally liable for the RETT. General RETT exemptions exist, eg, for transactions between related persons or transfers by way of inheritance. Other exemptions will rarely be of practical relevance.

RETT is levied on a number of other 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 where 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.

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 unification in the hand of one individual, partnership, or corporation of 95% of the shares in a company or partnership that owns real property;
- transfer of 95% or more of the shares in such a company or partnership; and
- direct or indirect change of the partners in a partnership-owning domestic real estate will also give rise to real estate transfer tax if the change is effected within a period of five years (see section below ‘Acquisition of a German property company’ – ‘Tax aspects’ – ‘RETT”).

In 2013, a new provision was enacted to abolish so called ‘RETT-Blocker-Schemes’. The wording aims to look through indirect holding structures and to consider any indirect holding for calculating the 95% threshold (under current law indirect holdings below the 95% threshold are not considered). As a consequence for calculating the 95% threshold, any direct and any indirect holding in a property company will be considered. The new rules apply on all transactions from 7 June 2013 on as the bill has been passed by the German Federal Parliament on 6 June 2013.

It has to be noted that the Ministry of Finance and the Federal States intend to amend the German RETTA in order to broaden its scope. For future developments regarding changes in the German RETT law, please find our Real Estate Tax Services NewsAlerts under www.pwc.de/real-estate-tax-services-newsalert-en.

Due to these 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 (see section below ‘Acquisition of a German property company’ – ‘Tax aspects’ – ‘RETT”).

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 real estate transfer tax. Such reorganisation must be governed by the German Reconstructions Act, eg, in form of a merger or spin-off, or similar statutory law of another EU/EEA country. As of 7 June 2013, the ‘Group Clause’ has been amended. Not only mergers and spin-offs will fall within its scope but also contributions of real estate into 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 will keep these 95% or more shares for at least five more
years after the reorganisation. The parent must qualify as entrepreneur according to VAT law.

However, with regard to this, several appeals (dated 25 November 2015) concerning RETT and EU issues are currently pending before the Federal Fiscal Court. Please note, in practice, section 6a RETT Act is currently not available due to transaction or (re-) structuring, even if a binding ruling was requested at the competent tax office. The Federal Fiscal Court has referred a case to the European Court of Justice (CJEU) and asked the CJEU for a preliminary ruling on the question whether the ‘group privilege’ according to section 6a RETT Act does constitute illegal State aid according to European State aid rules (decision of 30 May 2017, II R 62/14). Should section 6a RETT Act constitute illegal State aid, the ‘group privilege’ could not be applied anymore until the European Commission decided upon the compatibility with the internal market. Should the European Commission decide that the ‘group privilege’ was not compatible with the internal market, State aid granted within the past ten years would have to be paid back including interests. There is no protection of legitimate expectation within the European State aid rules.

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 taken into account, 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 legal form of a corporation into a partnership and vice versa will, however, not trigger real estate transfer tax.

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 federal States. A tax rate of 4.5% applies for real estate located in Hamburg. A tax rate of 5.0% applies for real estate located in Baden-Württemberg, Bremen, Mecklenburg-Western Pomerania, Lower Saxony, Rhineland-Palatinate, Saxony-Anhalt. A tax rate of 6.0% applies for real estate located in Berlin and Hesse. For real estate located in Brandenburg, North Rhine-Westphalia, Saarland, Thuringia and Schleswig-Holstein the applicable RETT rate is 6.5%. These tax rates are amended by the federal 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 capitalised earning method (Ertragswertverfahren) or asset value method (Sachwertverfahren). The regulations of real estate transfer tax apply, irrespective of whether or not the transaction itself is also subject to VAT. VAT is not part of the consideration for RETT purposes.
VAT

The basic concepts of the German VAT regime, such as taxable persons, nature of the goods, delivery of goods and supply of services have been brought into line with the EC 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 immovable 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 real estate transfer tax, 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 or leased. This includes lease financing activities in which the lessor is the economic owner.

Although transactions subject to real estate transfer tax (hereditary building rights excluded), especially the sale of real estate, are VAT-exempt, they may voluntarily be subjected to VAT. Such 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.

The aforementioned applies if a sale is effected to another enterprise for purposes of the latter’s business, regardless of whether the purchaser is entitled to recover input VAT (VAT option). The vendor may, under certain circumstances, opt to subject the sale to VAT either wholly or in part (see section below ‘Direct investments in German property’ – ‘Direct purchase of assets’ – ‘Tax aspects’ – ‘VAT’).

Under certain circumstances, the VAT option applies to the letting of real estate, the transfer of hereditary building rights and other rights in rem (see section below ‘Managing German real estate’ – ‘Tenancy’ – ‘Tax aspects’ – ‘VAT’). 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, then 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.

There is an important general exception. The sale of a whole business or an independent part of a business (Geschäftsveräußerung im Ganzen) to an entrepreneur is, in general, not subject to VAT. Even the disposal of one piece of real estate can fall into this category, if it represents the main business asset. Consequently, the purchaser 'succeeds' the seller in his VAT position.

With effect from January 2010 the place of supplied services have been introduced. Business-to-business (B2B) supplies of services are now generally VAT-able 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 keep being taxable at the place where the property is located.

The general VAT rate amounts to 19%. A reduced tax rate of 7% applies to letting accommodation for short periods, eg, by hotels.

Thorough VAT planning is important, because any VAT leakage resulting notably from non-recovery of input VAT may hit the tax efficiency of an investment accordingly.

**Land tax**

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 the 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 (Einheitswert). So far, the unitary value is based on value ratios of the properties as of 1 January 1964 (in the territory of the former West Germany) and 1 January 1935 (in the territory of the 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 was ruling upon referrals of the Supreme Tax Court and two complaints on the constitutionality of the valuation regulations in the former West Germany with regard to land tax.

The Court noted that the values of real estate applied for the calculation of the 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.

The Court ruled that the unconstitutional provisions should continue to apply in two stages. First, the old rules (for former West and East Germany) should continue to apply for valuations that have been assessed in the past as well for assessments made up to 31 December 2019. The German legislature is obliged to issue new valuation rulings to determine the unitary value by this date. Once the new rules are agreed, the old provisions should apply for a further five years but not longer than 31 December 2024.

If the German legislature has not issued new valuation rulings as of 31 December 2019, the application of the existing valuation rules will cease at the end of this date.

How exactly a possible new valuation of the unitary value will look, is still unclear (as of the beginning of September 2018). At the moment, various models are under discussion.

Irrespective of the future change of the valuation rules for the determination of the unitary value, the determination of the land tax is expected to remain unchanged.

It is 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 of 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 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 the deemed gross earnings (Rohertrag) from the real estate are reduced by more than 50% due to exceptional circumstances.
Real Estate Going Global – Germany

Direct investments in German property

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.

The characteristics and consequences of these various alternatives or options are outlined below, together with the tax and legal features regarding the construction of a new building.

Direct purchase of assets

Legal aspects

The right of ownership

Under 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 so-called ‘business fixtures’ (Betriebsvorrichtungen) as defined for tax purposes (these being depreciated as moveable 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 (Unbedenklichkeitsbescheinigung) confirming payment of real estate transfer tax.

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 so-called ‘business fixtures’ (Betriebsvorrichtungen), which are depreciated as moveable property regardless of whether they can be qualified as an integral part of the real estate under civil law. The depreciation terms generally follow the official depreciation tables.
Trade tax
If the acquisition of property subsequently involves activities 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. However, in the case of direct passive property management, trade tax will not be levied if the investor has neither a PE nor a permanent representative in Germany.

If the investor is a company with limited tax liability and is engaged in passive property management but is subject to trade tax because it maintains a PE, it should try to structure the activity in such a way that it qualifies for the so-called ‘extended trade tax deduction’ for passive real estate companies, thereby potentially reducing the tax base for trade tax purposes to zero. This may require some organisational changes in individual cases (see section above ‘Understanding the basic principles’ – ‘Trade tax’).

RETT
In contractual practice, it is generally agreed that the costs and taxes incurred during the transaction process such as real estate transfer tax and 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’ issue, 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 real estate transfer tax 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.

Acquisition of a German property company
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 liable 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 corporate income tax, 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. However, there are plans in German legislation to extend the treatment of portfolio investments to capital gains as well. 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.

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 corporate income tax 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 corporate income tax 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 EC Parent-Subsidiary Directive and any double taxation treaty (DTT) concluded with the acquirer’s home country. The non-resident company with so-called ‘limited tax liability’ is in principle subject to corporate income tax 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 EC 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 corporate income tax 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 corporate income tax. 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 corporate shareholders on the sale of shares in German corporations are exempt from German corporate income tax in full if certain conditions are met. According to the verdict full exemption from corporate income tax 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 2019. The German Ministry of Finance (Bundesministerium der Finanzen, or BMF) recently 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 ‘Definitive WHT regime’).

For tax exemption according to double tax treaties 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.

RETIT
The transfer of a shareholding in a corporation or an interest in a partnership as such is not generally subject to real estate transfer tax (RETIT). However, RETIT will be levied where, as a result of the transfer:
95% or more of the shares in a real property-owning partnership are transferred 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 real estate transfer tax. Certain cases of intra-group reorganisations are exempt from real estate transfer tax also (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 federal 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 above section ‘Direct investments in German property’ – ‘Direct purchase of assets’ – ‘Tax aspects’ – ‘VAT’.

**Construction and development**

**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 federal 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 where 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 where the aggregate consideration in any one calendar year falls below the de minimis threshold (of €15,000 or €5,000 - 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.

**Financial investments 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 German Capital Investment Code creates a unitary and cohesive system for all fund managers and all types of investment funds, especially, for close-end real estate investment funds which were not regulated before the implementation of the AIFMD.

The German Investment Code 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 German Capital Investment Code, 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 Finanzdienstleistungsaufsicht, or BaFin), prior to commencing operations.

The capital management company needs to procure for a regulatory capital of at least €125,000 (€300,000 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 close-end funds:
• Close-end Special AIF (geschlossene Spezial-AIF): only professional and semi-professional investors can obtain units in the fund.

• Close-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 case 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 investors is, inter alia,

(a) each investor

• who commits to investing a minimum of €200,000;

• 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 €10m.

• 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.

Close-ended German investment funds shall be launched only as investment stock corporations with fixed capital (Investmentaktiengesellschaft mit fixem Kapital) or
close-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-ended Special-AIF (offener Spezial-AIF): only professional and semi-professional can obtain units in the fund.

- Open-ended Special AIF with fixed investment rules (Spezial-AIF mit festen Anlagebedingungen): only professional and semi-professional investors can obtain units in the fund.

- Open-ended German Retail AIF (offener Publikums-AIF): offered to the public, both individuals and corporations can obtain units in the fund.

**Open-ended German Retail AIF (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 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 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 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-ended German Special AIFs**

Open-ended German Special AIFs are a sub-form of real estate investment funds and do not differ substantially from the retail open-end funds. In general, less investment restrictions are applicable on Special AIFs from a regulatory perspective.

With respect to open-ended 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 corporate income tax 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 monitored 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-ended 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 close-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 corporate income tax on the fund’s German sourced income.
The investment fund can achieve exemption of German corporate income tax 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 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 corporate income tax 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 at least 51% 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 at least 51% 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 at least 51% 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 is currently no clear guidance on how above thresholds are calculated in practice (eg, how to treat real estate holding companies).

**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; and
- 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 need 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 case of domestic income), WHT has to be levied on 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 draft circular to give guidance and explain certain interpretations. However, the latest available draft does not comment on all areas and 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 €15m. 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 corporate income tax and trade tax. This applies from the start of the financial year in which the registration as a G-REIT takes place.

In 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 above ‘Acquisition of a German property company’ – ‘Tax Aspects’).

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.

**Financing the acquisition of German real property**

**Capital contribution**

**Legal aspects**

There are various types of companies that may be used as a vehicle for real estate investments in Germany.

With a strict limitation of liability and flexible company law, a corporate entity with limited liability in the form of a GmbH is advantageous and the most common form of
an entity, rather than the less flexible form of a corporate entity – an AG – used by entities whose capital is subscribed after a public offering.

The GmbH is founded by drawing up notarised agreed statutes and may be set up by one shareholder. Its minimum subscribed capital is generally €25,000. Newly established companies may start with a subscribed capital of less than €25,000 (at least €1) if certain requirements are met (Unternehmergesellschaft, or UG). Depending on the size of the company, the annual financial statements may require certification by a certified public accountant (Wirtschaftsprüfer).

Notary and registration fees depend on the amount of subscribed capital. It is common practice in Germany to acquire shelf companies.

According to the German company legislation and case law, dividend distributions or any other repayments to the shareholder which result in the net equity falling below the subscribed capital are not permitted.

Companies can be flexibly funded, either with formal statutory capital, or, more easily, informal capital.

**Tax aspects**

For German tax purposes any contribution has to be accounted for on the level of the receiving corporation in a specific tax account. This so-called tax contribution account may very well differ from the equity shown in the German generally accepted accounting principles (GAAP) accounts. In case of a later distribution of funds to the shareholder, any distributable profits shown in the tax balance sheet are considered as distributed before any contribution can be repaid. This can have an effect on a WHT burden as only the distribution of tax profits is subject to a WHT.

There are no duties on capital contributions in Germany.

**Mezzanine capital**

It has to be examined on a case-by-case basis, whether debt or equity is given from a German perspective.

**Jouissance rights**

An investor may acquire jouissance rights (Genussrechte) in a German corporation that invests in real estate.

Jouissance rights are not defined in law, although they are frequently used by stock corporations. These rights are contractual and can be documented by bearer or registered certificates that can be listed on a stock exchange. The holder of jouissance rights has no voting rights and cannot participate in shareholder or management meetings. The profit share, expressed as a percentage of the amount of the investment, is generally higher than the prevailing interest rate. How much higher needs to be analysed carefully where the investor and the corporations are related parties, in order to avoid a hidden profit distribution under German tax law.

If the jouissance rights do not allow for participation in liquidation proceeds, the payments are fully deductible by the German entity for corporate income tax and 75% deductible for trade tax purposes. Otherwise, the treatment is similar to that of atypical silent partnerships (see below).
In some cases, traditional debt arrangements may provide a better after-tax result if the interest is not subject to WHTs under the relevant tax treaty.

**Atypical silent partnership**

An investor who lends capital under the above-mentioned terms of a silent partnership agreement may undertake in co-entrepreneurial investment and then be treated as a so-called atypical silent partner in the company investing in German real estate.

In comparison to a typical silent partnership, the silent partner in an atypical silent partnership generally has extended control rights. Moreover, they participate in liquidation proceeds (and hence in hidden reserves realised in the sale).

Under German tax law and under a number of tax treaties, such investors are treated as direct investors in the same way as partners under an ordinary partnership agreement. Therefore, such partners will often be considered as having a PE in Germany (no WHT on repatriated proceeds). If the atypical silent partner is a corporation, its profit share is taxed at a corporate tax rate of 15% (plus 5.5% solidarity surcharge = 15.825%).

In principle, the tax treatment for partnerships applies. However, the tax treatment in the foreign investor's home country needs to be carefully considered.

**Typical silent partnership**

An investor may as a silent partner lend capital to a company investing in German real estate. In German civil law terms, the typical silent partnership is an undisclosed partnership between the principal (e.g., a company holding real estate) and the silent partner.

The contribution of the silent partner is recognised in Germany as legal capital under certain circumstances. Shareholders may, in principle, also be silent partners. The silent partner possesses limited control rights. The silent partner has a P&L sharing entitlement in the principal's business. In liquidation, the silent partner does not participate in the liquidation proceeds. Under German tax law, the profit share of the silent partner is deductible for the principal, e.g., a corporation, in arriving at their income for corporate income tax purposes. However, the profit share is not deductible for trade tax purposes.

Foreign investors entering into a silent partnership may be treated as lenders or shareholders, depending on the applicable tax treaty. Special attention must be given to how the arrangement is treated in the foreign investor's home country. The income of the silent partner is generally subject to WHT at 25% (plus 5.5% solidarity surcharge), a rate that may be reduced under the relevant tax treaty.

**Profit participating loans**

Investments in real estate located in Germany can also be achieved by lending capital on the basis of a profit participating loan arrangement (*partiärische Darlehen*). A profit participating loan is similar to a traditional loan, except that the interest payments vary depending on the profits of the company. As a result, the lender may receive larger interest payments in profitable years.

The rate of return on profit participating loans is normally lower than that under a silent partnership arrangement as there is no loss-sharing provision.
Debt

Legal aspects
The (interim) financing of a German company can be achieved through shareholder loans or by senior loans from foreign or local banks. Local banks such as mortgage banks (Hypothekenbanken), building societies (Bausparkassen) and savings banks (Sparkassen) also specialise in real estate financing.

Mortgage (or land charge)
Regarding long-term financing of real property, the loan claim of the creditor is usually secured by an instrument such as a mortgage (Hypothek) or a land charge (Grundschuld). The features of mortgages and land charges may briefly be summarised as follows:

A mortgage always relates to a specific claim, ie, the settlement of the loan vis-à-vis the creditor, with the debtor being personally liable for securing the claim. Land charges, on the other hand, do not relate to a specific claim, but may eg, also be used to secure a number of other obligations vis-à-vis the same creditor or, if a loan has been settled, vis-à-vis another creditor. In contrast to a mortgage, under a land charge the creditor may only take recourse to the property if the debtor is not personally liable for securing the claim. Due to their flexibility, land charges are therefore widely used in Germany.

Deeds on mortgages/land charges are usually notarised and must be entered in the land register.

Tax aspects

Income tax
In general, interest paid under a loan agreement contracted for the acquisition of real estate is, for corporate income tax purposes, fully deductible provided that the investor can prove that the financing relates to the acquisition of the property. The fees paid in order to secure loans, such as notary’s and court fees, are also deductible. If the borrower generates business income, a discount (disagio) on the loan is not immediately deductible, but must be capitalised and written off over the period of the loan agreement.

However, there are the following significant restrictions on the general tax deductibility of interest payments.

Arm’s length principle
The terms of a shareholder, or related party loan must correspond with the arm’s length principle. Therefore, eg, the loan to value ratio and the interest rate must be at arm’s length.

Such loan agreements should be agreed in writing in advance and transfer pricing documentation can become necessary in a tax audit situation. Interest payments that do not meet the arm’s length requirements are not tax-deductible and can trigger deemed dividend distributions subject to WHT.

Interest capping rules
The ‘interest barrier rule’ (Zinsschranke) may restrict the tax deductibility of interest expenses. The rules do not only apply to interests paid on shareholder loans but to
interests 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 without time limitation, being 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 €3m annually.

• The German business is not part of a consolidated group of companies; and – in 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 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 could be used where no IFRS accounts are available.

Companies forming a fiscal unity for German tax purposes are regarded as one business in the meaning of the interest-capping rules.

The following checklist illustrates the applicability of the interest capping rules.
WHT on interest

WHT on interest payments is imposed only in a limited number of cases such as profit participating loans, silent partnership agreements, or loans granted to banks (including interest-bearing bank accounts). Therefore, it will, eg, not be levied on interest payments for loans granted by a foreign company to its German subsidiary.

In a rare case the tax authority can levy a WHT of 25% or 15% (for corporations) in its discretion, if this can secure an effective taxation of the non-resident payee. However, we have not seen such an obligation to withhold taxes on interest payments in the real estate sector. Taxpayers with limited tax liability receiving interest on loans secured by mortgage on German property are, in principle, subject to tax by assessment. However, most tax treaties provide for an exemption of all interest income from German tax.

Interest received

Interest income is included in a German company's taxable profit and will, as such, be subject to tax at the normal rate.

Under most of Germany's tax treaties, interest income received by a non-resident lender is only taxable in the latter's country of residence.
Due to special regulations for the taxation of partnerships, interest payments to a partner by a German partnership are treated as appropriations of profit and are not deductible in the course of determination of the taxable income basis of the partnership.

**Trade tax**
If certain limits are exceeded, 25% of any interest expenses which were deducted from the taxable income are added back to the trade tax base.

**Managing German real estate**

Most frequently, the legal format for administering real properties will be one of the following: the mere renting of the property, the concession of rights in rem thereon, or the conclusion of a financial lease agreement.

**Tenancy**

**Legal aspects**
Contrary to Anglo-American legal principles, leases in Germany are classified not as estates but as contracts. They are therefore not entered in the land register.

Commercial leases can be defined as leases of premises or parts of premises that are used principally by the lessee or by a sub-lessee for business purposes.

Residential leases can be defined as leases of accommodation that the lessee uses for the purpose of their principal residence.

German civil law provides special rules for lease agreements. However, contractual terms can be negotiated in many aspects.

In contrast to hereditary building rights (*Erbbaurechte*) and usufruct (*Nießbrauch*), the lease does not confer upon the lessee any right in rem. In fact, the lease only gives rise to personal rights, i.e., rights of claim against the lessor to enjoy the rented asset.

**Tax aspects**

**Income tax**
For private domestic investors, income derived from the letting of property is generally deemed to be ‘rental income’. However, because of their legal form, resident companies are deemed to generate ‘business income’ from their letting activities. Rental income of foreign investors is also qualified as ‘business income’. The difference is that ‘rental income’ is generally determined on a cash basis, whereas ‘business income’ is generally determined on an accounting basis.

Related expenses such as depreciation (see section above ‘Direct investments in German property’ – ‘Direct purchase of assets’ – ‘Tax aspects’ – ‘Income tax’), maintenance and financing costs, etc can be deducted in the amount actually incurred.

**VAT**
As a general rule, the letting of immovable property is VAT-exempt, with the following exceptions:

- Letting of accommodation for short periods by an entrepreneur.
• Letting of camping areas for short periods.
• Letting of vehicle parking space.
• Letting of machinery and so-called ‘business fixtures’ (*Betriebsvorrichtungen*).

However, for the first two exceptions a reduced tax rate of 7% applies.

The exemption from VAT can generally be waived by the lessor if a building is let to an entrepreneur for business purposes, unless the services of the lessee, eg, banks, municipalities or hospitals, are VAT-exempt.

If buildings are let partly for commercial and partly for housing purposes, the VAT-option can only be applied to the commercially used space.

In case a lessee carries out both VAT-liable and VAT-exempt services, the lessor may generally only charge VAT on that portion of the rent that can be attributed to the VAT-liable turnover.

Though the VAT-option can only be exercised by the lessor, they will usually be prepared to negotiate with the lessee on its application in order to optimise recoverable input VAT for the lessor and avoid non-recoverable VAT for the lessee, resulting in lower acceptable rentals.

In case the VAT option is exercised only for part of the letting turnovers, then the input VAT may also be recovered in part only. In this connection, the relevant ratio is generally to be determined with regard to the spaces let; only if this is impossible may the ratio be determined with regard to the proceeds generated.

**Hereditary building right and usufruct**

Rights *in rem* are quite common in the German real estate business. For the ‘lessee’, they usually confer more stability than a mere rent; for the ‘lessor’, they usually guarantee revenues over a long period of time.

In some circumstances, the acquisition of rights *in rem* can be considered as an alternative to a purchase. Rights *in rem* are, in fact, usually concluded for a long period and give extended rights to their holder.

**Legal aspects**

**Hereditary building right (Erbbaurecht)**

A hereditary building right entitles its holder to erect and own, or acquire buildings, works, or plantations on land that remains in the legal ownership of the grantor. For the duration of the holder's right, the holder is the sole legal owner of such erected assets. The holder may use, enjoy, or demolish them, provided that the holder returns the land in the condition in which they obtained it.

A hereditary building right usually is granted for a period of 30 to 99 years. As there are no statutory time restrictions, it can also be granted for a shorter or longer period.

The holder may transfer the hereditary building right and pass it on by way of succession. The right can be encumbered with easements and mortgages.
For the purchase and transfer of hereditary building rights, in principle the same rules apply as on the acquisition of property.

Instead of a purchase price, the holder will usually pay an annual rent (land rent, *Erbbauzins*) to the grantor.

**Usufruct (Nießbrauch)**

Usufruct is a restricted right *in rem*, which allows the usufructuary to temporarily use and enjoy real or personal property belonging to a third party, provided that its substance is preserved.

The usufructuary will usually assume certain costs relating to the property, such as public charges (eg, land tax), mortgage liabilities, insurance costs and costs for small repair work. The grantor, on the other hand, bears the maintenance costs and costs for considerable repairs and depreciation. However, the parties may stipulate other contractual terms.

The right of usufruct is typically granted for a long-term period. It can neither be transferred nor pledged.

If the usufruct is granted for a let property, the lessees must be notified of its settlement. New lease contracts will usually be concluded by the usufructuary.

**Registration duties**

The grant of rights *in rem* must be notarised and entered in the land register. The grant of a hereditary building right is entered in a special annex to the register, the building right register (*Erbbaugrundbuch*).

**Tax aspects**

**Income tax**

For tax purposes, the grant of a hereditary building right or usufruct is basically treated like a ‘normal’ lease contract.

**Hereditary building right**

The holder has to capitalise the expenses connected with the transfer of the hereditary building right, such as notarial fees and real estate transfer tax, as acquisition costs of the hereditary building right. Such costs are depreciable over the term of the agreement. The land rent constitutes an immediately deductible business expense.

Advance payments for long-term transfer of use (hereditary building rights) are deductible as business expenses: if the advance payments relate to a period of up to five years, immediately; if they relate to a longer period, they are deductible only *pro rata temporis* over the term to which they relate.

If the hereditary building right is granted for land with buildings, the buildings must be listed at acquisition costs, ie, the capitalised value of the land rent, in the holder’s accounts.

If the holder erects a building, it is to be stated as construction costs. The usual depreciation rates for buildings are applicable (see section above *Direct investments in German property* – *Direct purchase of assets* – *Tax aspects* – *Income tax*).
For the grantor, the land rent in principle constitutes (immediately) taxable income. In the case of advance payments relating to a period of more than five years, the grantor may elect to spread the respective income over the period to which it relates.

**Usufruct**

Taxation mainly depends on the usufructuary being classified as the user of the property or as its economic owner. Here, the contractual relationship in each individual case should be considered.

If the grantor remains the economic owner of the property, the usufruct is basically treated like a normal lease contract. For the grantor, the payment(s) received for granting the right are taxable income. They may deduct expenses relating thereto, as well as depreciation on the building.

The usufructuary, on the other hand, may depreciate the cost of the usufruct right over its lifetime. If the usufructuary sublets the property to a third party, they generate rental income. Expenses such as maintenance costs, etc are deductible.

The conditions for the attribution of economic ownership to either the usufructuary or the grantor are regulated in a decree of the Federal Ministry of Finance and by case law. According to these rulings, economic ownership is allocated to the usufructuary if they have the control of the property over its useful life and bear all costs relating thereto, ie, not only the public charges but also costs for maintenance and repair. As a result, they are entitled to claim the depreciation on the real estate.

Usufruct agreements may be regarded as an alternative to long-term lease agreements and may serve as a flexible instrument to achieve the desired income tax position as purchaser or lessee and sub-lessee, without being considered the legal owner of the property.

**RETT**

The transfer of a hereditary building right is subject to real estate transfer tax. The tax basis is the capitalised value of the ground rent. By contrast, the grant of a usufruct is not subject to real estate transfer tax.

**VAT**

The grant and transfer of rights *in rem* in real estate is exempt from VAT. The grantor may, however, opt to charge VAT if the holder is an entrepreneur who will exclusively use the property for business purposes, entitling them to recover input VAT.

**Real estate financial leasing**

Real estate financial leasing may offer considerable cost and tax advantages in addition to the benefits of off-balance-sheet financing for the lessee if the leasing agreements are carefully drafted. Subsidiaries of German banks, in particular, have acquired expertise in these financial investments.

In the following, the structure and tax implications of real estate financial leasing are discussed with regard to the applicable economic ownership concept.
Legal aspects

Under a real estate financial leasing agreement the landlord leases for a certain long-term period real estate to the tenant for a consideration in form of a rent. The lessor finances the erection of a building on the plot of land for the use of the tenant.

Contrary to a ‘normal’ lease contract, the tenant is generally liable for maintenance costs and liabilities in connection with the destruction of, or damage to, the property. When concluding the agreement, they are usually granted a purchase option for the property on termination of the lease agreement. The financial leasing may, as a result, be considered an alternative to a normal lease or the acquisition of real estate.

Contracts on real estate leases must be concluded in written form. If a purchase option in favour of the lessee is agreed, the agreement requires notarial form. The purchase option is entered in the land register as a priority notice.

Tax aspects

Financial leasing may be advantageous for the lessee under certain conditions.

To achieve these advantages, the lease agreement should be drafted in such a way that the tax authorities consider the lessor as the economic owner of the land and building for tax purposes.

The economic owner is the person who is able to, and usually does, exclude the legal owner from the use of the asset for the remainder of its assumed useful life, ie, for a period long enough to reduce the value of the property to a point where the legal title is economically insignificant.

A decree issued by the Federal Ministry of Finance sets out standardised procedures for the attribution of economic ownership for leased immovable property to the lessee or the lessor, respectively. In such leases, the economic ownership position must be determined separately for land and buildings, with ownership for the land following the decision on economic ownership for the buildings.

Economic ownership is vital for the decision on who is to carry the leased asset in their balance sheet and depreciate it. Whereas the legal owner is normally considered the economic owner of the building, the decree contains a number of provisions according to which economic ownership is attributed to the lessee. The allocation of the real estate to either the lessee or the lessor depends mainly on the duration of the agreement in relation to the normal useful life of the building and the material risk (cost and charges) assumed by the lessee under the agreement. As these rules are rather strict and therefore largely indisputable, this should enable the parties to stipulate contractual terms that may lead to an optimal arrangement for tax purposes.

Lessor as economic owner

If the lessor is considered to be the economic owner of the land and building, leasing agreements are treated as ‘normal’ lease contracts for tax purposes. In practice, this is used for tailor-made off-balance-sheet financing or closed-end funds.

Income tax/corporate income tax

The lessor must capitalise the leased property at acquisition/construction costs in their balance sheet and must depreciate it over the property’s useful life. The rentals received are taxable income. Interest on loans taken up to finance the real property is
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The lessee does not need to capitalise the leased asset in their balance sheet. They must, however, disclose the leasing obligations in the notes to the accounts. The rent paid is immediately deductible.

**Trade tax**

If the lessor is not exempt from trade tax on earnings, their taxable income is increased by 25% of the interest on borrowings for trade tax purposes to the extent certain amounts are exceeded. On the other hand, 1.2% of the unitary tax value of property belonging to the assets of the business can be deducted. If the lessor establishes a real estate company, they can make use of the ‘extended trade tax deduction’ if the conditions for its application are met (for details see section above ‘Trade tax’).

There are no disadvantageous trade tax implications on the tenant, as the long-term financing is assumed by the lessor.

**VAT**

If the lessor is the economic owner of the real estate for VAT purposes, the lease is treated as renting (see section above ‘Managing German real estate’ – ‘Tenancy’ – ‘Tax aspects’ – ‘VAT’) with every single rent being subject to VAT.

**Lessee as economic owner**

In case the lessee is considered to be the economic owner of the property, leasing agreements for tax purposes are viewed as a sale of real estate by instalment.

**Income tax**

The capital gain derived by a resident lessor from the ‘sale’ of the real estate is generally taxable at standard tax rates if it is classified as ‘business income’ or as ‘income from capital gain’. In addition, a capital gain derived by non-residents on the sale of German real estate is, in most cases, also subject to individual or corporate income tax in Germany (see section below ‘Selling real estate’ – ‘Tax aspects’).

The lessee must disclose the ‘purchased’ asset in their balance sheet and is entitled to depreciate the capitalised building costs. On the other hand, the corresponding liability for the future instalment payments to the lessor must be reported in the balance sheet. The interest portion contained in the instalment payments is a deductible business expense, whereas the capital portion will amortise the liability. Tax on interest will only be levied if a mortgage or land charge is provided as security for a non-resident lessor. In such a case, tax is assessed at the normal corporate income tax rate imposed on non-resident enterprises (namely 15% plus 5.5% solidarity surcharge thereon, adding up to 15.825%) unless the applicable tax treaty provides for an exemption.
RETT
The economic ownership concept for income tax purposes is not applicable for RETT purposes, ie, a change in economic ownership from an income tax viewpoint does not automatically trigger RETT.

The RETT Act provides for taxation of a transfer if the recipient has de facto reached a position similar to the entitled legal owner. In this case, the recipient is able to benefit from all substantial proceeds from the use or disposal of the real property. In practice, standard financial lease agreements should not trigger RETT, whereas agreements that transfer economic ownership to the lessee most likely will.

Whether or not a lease agreement on real estate triggers RETT therefore depends on the individual contractual terms, in particular on the rights and obligations assumed by the lessee under the agreement.

VAT
If the lease is considered a sale for income tax purposes, it will also be viewed as a taxable supply of goods for VAT purposes, albeit exempt from VAT. The exemption may be waived under certain circumstances (see section above section ‘Direct investments in German property’ – ‘Direct purchase of assets’ – ‘Tax aspects’ – ‘VAT’). In this case, the accumulated instalment payments (without interest) plus the price for the purchase option form the tax base.

Selling real estate

Legal aspects
Regarding the legal aspects of the sale of real properties see section above ‘Direct investments in German property’ – ‘Direct purchase of assets’ – ‘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 corporate income tax 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 accruals 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 ‘Understanding the basic principles’ – ‘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’ – ‘Direct purchase of assets’ – ‘Tax aspects’.

Conclusion

As with any investment, the optimal real estate investment structure depends on the special objectives and needs of the investor.

Use of investment strategies therefore usually depends on the following:

- status of investors (fund, individual, company, etc);
- goals of investors (long-term/short-term; desired income generation);
- kind of investment (development, management, trading);
- legal status of investment at the time of investing (fund, individual, company, etc);
• requirements of potential local or financing partners;
• other requirements (preserving current legal status); and
• various issues.

Long-term investments aimed at generating a considerable rental yield and a future increase in value, resulting in capital gains, may be structured through German subsidiary companies eligible to qualify for the international participation exemption.

The German income determination rules generally allow reasonable depreciation rates and the deductibility of allocated costs. Therefore, proper structuring will most likely lead to the tax burden on rental income being relatively low or even zero. For the acquisition of real estate companies, the optimal structure in some cases can only be reached by an initial restructuring, for which the German reorganisational commercial and tax laws provide a number of instruments.

Institutional investors aiming at investments of considerable size should carefully consider the use of investment funds (see section above ‘Financial investments in German real estate’).

Short-term investments aimed at the realisation of capital gains by trading in real estate or developing real estate should be structured carefully; parallel to this, all other activities of the investor in Germany must be taken into consideration in order to determine the lowest tax burden achievable.
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Greece

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Greece

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 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.

Tax laws L. 4172/2013 and 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):

<table>
<thead>
<tr>
<th>Rental income (€)</th>
<th>Tax rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 12,000</td>
<td>15</td>
</tr>
<tr>
<td>12,001 to 35,000</td>
<td>35</td>
</tr>
<tr>
<td>Over 35,001</td>
<td>45</td>
</tr>
</tbody>
</table>

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 is 29% for income earned during 2015 onwards. By virtue of L. 4472/2017, any business income realised by legal persons/legal entities as of 1 January 2019 shall be taxed at a rate of 26%. The reduction of the corporate income tax (CIT) rate from 29% to 26% shall be applicable on the condition that there is no divergence from the medium-term budgetary objectives set in the Economic
Adjustment Program following an assessment of the International Monetary Fund (IMF) and the European Commission in collaboration with the European Central Bank (ECB), the European Stability Mechanism, and the Greek authorities.

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:

<table>
<thead>
<tr>
<th>Total net income for the tax year 2018 onwards €</th>
<th>Special solidarity contribution rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 12,000</td>
<td>0</td>
</tr>
<tr>
<td>12,001 to 20,000</td>
<td>2.2</td>
</tr>
<tr>
<td>20,001 to 30,000</td>
<td>5</td>
</tr>
<tr>
<td>30,001 to 40,000</td>
<td>6.5</td>
</tr>
<tr>
<td>40,001 to 65,000</td>
<td>7.5</td>
</tr>
<tr>
<td>65,001 to 220,000</td>
<td>9</td>
</tr>
<tr>
<td>Over 220,001</td>
<td>10</td>
</tr>
</tbody>
</table>

Further, by virtue of the recently enacted L. 4472/2017, it is envisaged that as of 1 January 2020, and subject to the condition that Greece meets the medium-term budget targets under the financial adjustment programme as determined by the IMF and the European Commission in conjunction with the ECB, the European Stability Mechanism, and the Greek authorities, the following rates will be applicable on the overall net income with regard to the extraordinary special solidarity contribution:

<table>
<thead>
<tr>
<th>Total net income for the tax year 2020 onwards €</th>
<th>Special solidarity contribution rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 30,000</td>
<td>0</td>
</tr>
<tr>
<td>30,001 to 40,000</td>
<td>2</td>
</tr>
<tr>
<td>40,001 to 65,000</td>
<td>5</td>
</tr>
<tr>
<td>65,001 to 220,000</td>
<td>9</td>
</tr>
<tr>
<td>Over 220,001</td>
<td>10</td>
</tr>
</tbody>
</table>

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.

**Thin capitalisation rules**

According to the relevant thin capitalisation rules, any interest expense shall not be recognised as tax deductible business expense to the extent that the excess interest expense exceeds 30% of the taxable profits (earnings) before interest, taxes and depreciation (EBITDA). Said profits are determined based on the financial statements drafted by virtue of the Greek accounting rules, also taking into account the tax adjustments stipulated in L. 4172/2013.

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 €3m 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 a rate of 4%.
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;
- The construction licence 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.

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 a 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 *Societe 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 exempt:

• companies (SAs, Ltds and Partnerships) with registered shares all the way up to an individual, provided that the companies are resident in Greece or in another EU Member State and the ultimate individual shareholders maintain a Greek tax registration number (ΑFΜ);

• companies owned by banks and institutional investors, without having the obligation to disclose their ownership up to the individual, provided that the latter are not established in a ‘non-cooperative’ state and are supervised by a recognised authority of the respective state. ‘Non-cooperative’ states are defined in article 65(3) of the Greek Income Tax Code (as recently amended by L. 4549/2018) as states that are not EU Member States, and their status as to transparency and exchange of information in tax issues has been reviewed by the OECD and has not been characterised as “to a great extent compliance”, and which: (i) have not conducted and do not implement a DTT with Greece, or have not signed the Common Agreement between the European Council and the OECD regarding the Multilateral Convention of Mutual Administrative Assistance, and (ii) have not agreed for the automatic exchange of financial information as of 2018 the latest.

• shipping or ship-owner companies that have established offices in Greece for the property they use or lease to other shipping companies exclusively as offices or warehouses;

• companies with shares listed on an organised exchange;

• companies (irrespective of the country of their establishment), exercising commercial, manufacturing or industrial activity in Greece, provided that in the corresponding tax year the gross revenue from this manufacturing/business activity is higher than the gross revenue from the real estate property. Real estate used by the company for business activities, other than real estate exploitation, is not included in the calculation;

• legal entities which pursue charitable, cultural, religious and educational aims, for the buildings used for such purposes, as well as for empty buildings or property they exploit, provided that any gains arising are made available for the above mentioned purposes;

• insurance funds or social security organisations as well as companies of collective investments in real estate supervised by a competent authority of their registered seat, except for those whose registered seat is in a ‘non-cooperative’ state;

• companies whose registered shares or parts belong to a national or foreign institution, which seeks charitable purposes in Greece, for the buildings used for such purposes;
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 wholly 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 29%.

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 to 31 December 2018.

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 (e.g., 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 to €13 per square metre and other coefficients affecting the value of the property (e.g., 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 €0.003 to €11.25 per square metre and other coefficients affecting the value of the property (e.g., 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 0.1% to 1.15% with a tax free threshold of €250,000 of the total value of property rights subject to ENFIA, excluding the value of plots outside urban planning (agricultural plots) for the year 2018. The supplementary tax on legal entities or other entities is imposed at a tax rate of 0.055% on the total tax value of the subject property rights. This rate is reduced to 0.01% 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 (e.g., 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.

Nevertheless, L. 4389/2016 has introduced a minimum tax for REICs that significantly increased their tax leakage. Moreover, L. 4514/2018 (through which MiFID II Directive has been implemented in the Greek legislative framework) has recently 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:

- Those having a unit trust form (Real Estate Mutual Funds, or REMFs). REMFs are not listed vehicles.
- 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 (REMФ)**

A real estate mutual fund is managed by a fund management company, or Anonimi Eteria Diachirisis Amiveon Kefaleon (AEDAK), formed as an SA, which must have a minimum paid-in share capital of at least €2,935,000 (article 2(5)(a)). Such a mutual fund is established following a licence granted by the Capital Market Commission (CMC). The assets under management must amount to at least €29,347,028.61. (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 securities with a percentage not exceeding 10% of AEDAK’s share capital, and in cash, bank accounts and credit titles of equivalent liquidity with a percentage of at least 10% of the fund’s assets (article 6(1)). 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 (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 an 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 an SA, exclusively engaging in the management of portfolios comprising of securities and real estate, with a minimum share capital of €25m. 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 includes:
a) 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;

b) 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 €10m in value; and

c) a participation of at least 80% in UCITS investing in real estate investment companies, REITs and Alternative Investment Funds 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 its net equity in properties acquired under financial leasing contracts, and no individual contract individually can exceed 10% of the net equity. 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 it cannot exceed another two years 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, with no further tax obligation being imposed on the company or its shareholders. The minimum tax per semester should not fall below 0.375% on the average value of assets of the REICs as depicted in the semestrial tables of investments. Furthermore, the transfer of REIC shares that are not listed on the Athens Stock Exchange is not subject to any income tax. The transfer of 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 the Uniform Tax on the Ownership of Real Estate Property and 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 15% withholding tax is imposed on profits distributed by Greek *Societe 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 15% withholding tax. For dividends received by REICs, the 15% 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.

**Losses carried forward**

Greek operating companies may carry forward their losses for a period of five years. Company losses cannot be carried back. Further, based on recently enacted L. 4549/2018 (amending the provisions of L. 4172/2013), if given a tax year, the direct or indirect ownership of the share capital or the voting rights of an entity change in percentage that exceeds 33%, 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, L.D. 1297/1972, and specific provisions of L. 4172/2013 (as supplemented by L. 4438/2016), 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:

- 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.

- 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 Law 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 Law 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 Law 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 Law 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 and €0.073 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 per day;
- for 3 star hotels: €1.50 per day;
- for 4 star hotels: €3 per day;
- for 5 star hotels: €4 per day; and
- for rented furnished rooms/ apartments: €0.50 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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Real Estate
Going Global
Hong Kong

Tax and legal aspects of real estate investments around the globe

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information used in this content, unless otherwise stated, is up to date as of 26 July 2018.
Real Estate Tax Summary − Hong Kong

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. 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 has recently introduced a two-tiered profits tax rates regime for corporations and unincorporated businesses. Under the two-tiered profits tax rates regime, the profits tax rate for the first HK$2 million of assessable profits will be lowered to 8.25% (i.e. half of the prevailing standard tax rate of 16.5%) for corporations and 7.5% (i.e. half of the prevailing standard tax rate of 15%) for unincorporated businesses such as partnerships and sole proprietorships. Assessable profits above HK$2 million 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 the lender is subject to tax on the interest income in Hong Kong, or if the lender is a financial institution and the loan is not secured or guaranteed by any deposit or loan, the interest from which is not subject to tax in Hong Kong.

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 at the rate of 15% on the higher of the sales consideration or market value of the Hong Kong residential property. In respect of non-residential property, unless specifically exempted, the transfer would be subject to Hong Kong *ad valorem* stamp duty of up to 8.5% on the higher of the sales consideration or market value of the Hong Kong non-residential property.

The *ad valorem* stamp duty is normally payable by the purchaser.

**Special Stamp Duty**

Hong Kong 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.

<table>
<thead>
<tr>
<th>Period within which the residential property is resold or transferred after its acquisition</th>
<th>SSD rates (for residential property acquired on or after 27 October 2012)</th>
</tr>
</thead>
<tbody>
<tr>
<td>6 months or less</td>
<td>20%</td>
</tr>
<tr>
<td>More than 6 months but for 12 months or less</td>
<td>15%</td>
</tr>
<tr>
<td>More than 12 months but for 36 months or less</td>
<td>10%</td>
</tr>
</tbody>
</table>

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 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%.

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. 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. A resident company may distribute its retained earnings to shareholders, whether resident or non-resident, tax-free.

Loss carryforward

Operating 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

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All information used in this content, unless otherwise stated, is up to date as of 15 August 2018.
Legal considerations

Basic principles

Certain rights (including ownership) and physical 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 plot 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. In order to be valid and effective, the transfer of ownership or the transfer or establishment of any right over real properties must be registered with the Land Registry.

As a general rule, an entry related 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. In most cases legal representation is compulsory in Land Registry procedures. The Land Registry Offices must decide on applications for registration in the order in which they were filed. Some specified rights over a real property (for example ownership) are constituted by their registration in the Land Register. Accordingly, these rights can only be exercised once they have been officially registered.

Bona fide third parties acquire ownership in spite of the actual legal status, if they acquired the property for consideration and with the assumption that the entries in the Land Register are correct (i.e., they purchased the property from a registered owner).

Ownership by a local company

Hungarian corporate law recognises four principal corporate forms. A limited liability company (Kft.), which requires a minimum of 3m Hungarian forint (HUF) - approximately €10,000 - 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 5m HUF (approx. €16,000) as registered capital is required. The required minimum registered capital for a public company limited by shares (Nyrt.) is 20m HUF (approx. €63,000). 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. In certain cases, the owner of a Bt. and a Kkt. has unlimited liability towards the creditors of such an entity. All of these corporate forms may acquire the ownership of any Hungarian real property without 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 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. 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.

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 and decreasing items (eg, tax depreciation, thin capitalization, 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 minus the acquisition price of the shares less the costs of acquisition. 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:

• at least 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 tax treaties in the past that provide treaty protection for such transactions, however renewed treaties 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. 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.

**Thin capitalisation**

Interest on loans – shown under expenses or capitalized as asset cost –, other than loans from financial institutions may not be deducted for tax purposes on the portion of the loan that exceeds a 3:1 debt-to-equity ratio.

For thin capitalization purposes debt includes non-interest bearing loans as well, and back-to-back arrangements are exempted from the thin capitalization calculation (at the level of the entity which both receives and provides loans, ie, is in the middle of the financing arrangement).

Please note that due to the Anti-Tax Avoidance (ATAD) Directive, the aforementioned thin capitalisation rules are expected to change and an earnings before interest, taxes, depreciation and amortization (EBITDA) based interest limitation rule is expected to be introduced.

**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.

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 (CFC’s) 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 CPC definition is generally in line with that of the EU ATAD’s).

Shareholdings/investment units in a real estate investment fund (REIF) cannot be reported based on recent changes in the CDTA (effective as of 25 August 2018).

**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, i.e., 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 three times the company’s net equity, 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 2025 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.

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.
**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 and material costs (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.

Tax treaties do not apply to local business tax except for the Polish-Hungarian and the Albanian-Hungarian tax treaty.

**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 1,853.9 HUF/sqm in 2018), 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 337 HUF/sqm in 2018);

- 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 State Tax Authority. The tax base for the innovation contribution liability equals to 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 small enterprises. The thresholds (headcount number, the revenue and the balance sheet total) for small enterprises are calculated currently on a standalone basis however, this standalone calculation method will change to a group based calculation method as of 1 January 2019.

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.

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 2 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 tax payer starts certain business activity. The decision to treat a normally VAT-exempt transaction as VATable cannot be changed for 5 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. €3.1m) and 2% above, but it is capped at 200m HUF (approx. €620,000). 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.

A 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 200m HUF (approx. €620,000) 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. €3.1m) and 2% above, but it is capped at 200m HUF (approx. €620,000). 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 trusts (REITs)

Hungarian REITs are stock corporations (seated in Hungary or in any other state in the EEA), and listed on a regulated market within the EU with at least 25% of public ownership.

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 financial statements.

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 withholding tax.

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 funds (REIFs)

Background

Pursuant to Hungarian legislation (Act XVI of 2014), real estate investment funds are collective investment vehicles with legal personality, not operating though in a corporate form. Rather, they qualify as an unincorporated asset fund where all the investment decisions are made by the fund manager in the name and on behalf of the fund. Fund managers 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 established either publicly or privately, for a definite or indefinite duration, and also with closed-end or open-end terms (based on whether redemption of the investment units is possible during the fund’s term).

Regulation

The National Bank of Hungary is the responsible body for the licensing and supervision of the investment funds and the fund management companies.

Minimum level of initial capital

The minimum initial capital is 1 billion HUF (approx. €3.1m) for public, and 500m HUF (approx. €1.6m) 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 initial capital.

Investment restriction

For the purposes of the real estate investment funds, the scope of eligible assets is quite broad and may include – amongst others – Hungarian and foreign real estate properties, securities, derivatives, rights attaching to real estate properties (eg, usage rights) and investments in real estate rich companies.

In the case of public real estate funds, real estate portfolio diversification requirement applies (eg, the value of a single real estate property should not exceed 20% of the total assets in the case of open-ended public funds) and the gearing ratio is capped at 60%. However, in the case of private funds such restrictions may be disregarded.
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 tax treaties.

**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. €3.1m), and 2% for the exceeding part, while the tax is capped at 200m HUF (approx. €620,000) 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 withholding tax on distributions/payments made to entities. Thus, foreign entity investors can realise the fund’s proceeds withholding taxfree.

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

Tax and legal aspects of real estate investments around the globe
2018
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Real Estate Tax & Regulatory Summary – India

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), Person of Indian Origin (PIO) 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 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.

Creating a vibrant Real Estate Investment Trusts (REITs) market has been on the agenda of the regulators in recent times. Facilitating amendments in the Indian Exchange Control Regulation as well as tax laws are made in order to provide enabling environment for the REITs.

Applicable taxes

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 rate of 30% (plus applicable surcharge and education cess) after allowing deduction of all permitted business expenses.

In case income is characterised as income from house property, such income would be taxable at the rate of 30% (plus applicable surcharge and education cess) 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, operation and maintenance of specified infrastructure facilities, etc.

Capital gains earned on transfer of immovable property (ie, not held as stock-in-trade) are taxable either as short term capital gains (if said property is held for up to 24 months) or long term capital gains (if said property is held for more than 24 months), taxable at 30% (plus applicable surcharge and education cess) and 20% (plus applicable surcharge and education cess) respectively.1

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1 In case of person being non-resident same would be taxable at rate of 40% (plus applicable surcharge and education cess) or 10% (plus applicable surcharge and education cess) respectively.
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 same would be compared with Fair Market Value (FMV) as per the prescribed methodology.

Capital gains earned on transfer of unlisted securities\(^2\), is taxable either as short term capital gains (if property held for up to 24 months) at 30% or long term capital gains (if held for more than 24 months) at 20% (plus applicable surcharge and education cess) for unlisted securities\(^3\).

Capital gains earned on transfer of the specified\(^4\) listed securities (ie, not being held as stock-in-trade) transferred on the recognised stock exchange in India on or after 1 April 2018, is taxable either as short term capital gains (if same held for up to 12 months) at the rate of 15% or is taxable as long term capital gains (if held for more than 12 months) at the rate of 10% (plus applicable surcharge and education 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.

Where the tax liability of an Indian company, computed in the prescribed manner, is less than 18.5% of the adjusted book profits of the company, tax at 18.5% (plus applicable surcharge and education cess) is payable by the Indian company.

\(^2\) 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.

\(^3\) In case of a person being non-resident, same would be taxable at the rate of 40% (plus applicable surcharge and education cess) or 10% (plus applicable surcharge and education cess) respectively.

\(^4\) equity share in a company or a unit of an equity oriented fund or a unit of a business trust
Real Estate Investments – India

Regulatory

Direct investments in real estate property
NRI and PIO 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 farm houses and trading in transferable development rights. Real estate business is defined under the FDI regulations as follows:

‘Real estate business’ is 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, townships. Earning of rent income on lease of the property, not amounting to transfer, will not amount to real estate business.

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.

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;
- Real estate broking services and 100% foreign investment is allowed in real estate broking services under automatic route.

Under the FDI route, a person resident outside India is allowed to invest in ‘permitted securities’, wherein the investment is made on the repatriable basis. Permitted securities include equity shares, compulsorily convertible preference shares, compulsorily convertible debentures and share warrants issued by an Indian company.

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 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.

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 aforementioned conditionalities (including lock-in) in case of development of SEZs, Hotels and Tourist Resorts, Hospitals, Educational Institutions, Old Age Homes and investment by NRIs/Overseas Citizens of India (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.

Regarding the FDI policy, 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.

Separately, a SEBI Registered Foreign Portfolio Investor (RFPI or FPI) can invest in listed non-convertible debentures issued by an Indian company. Recently, few changes affecting operational aspects of FPI investments in debt, including introduction of concentration limits for an FPI for its corporate bond portfolio to a single corporate, have been undertaken. Key changes of the same have been discussed below:

- Minimum residual maturity for investments in corporate bonds reduced from three years to one year;

- Investments by an FPI not to exceed 50% of the issue size;

- Exposures to a single corporate not to exceed 20% of FPI’s corporate bond portfolio.

**External commercial borrowings (ECBs)**

Under the extant ECB framework, the borrowers eligible to borrow by way of ECB are categorised as follows:
• Companies in infrastructure sector (viz. industrial parks, hospitals, hotels, etc), to be covered under Track I;

• REITs and Infrastructure Investment Trusts (InvITs) registered with SEBI are allowed to raise ECBs in foreign currency, to be covered under Track II; and

• Developers of SEZs/National Manufacturing and Investment Zones (NMIZ), to be covered under Track III.

Minimum Average Maturity (MAM) for Track I and Track III is mentioned below:

• In case of up to US$50m or its equivalent: three years;

• Beyond US$50m or its equivalent: five years.

However, Infrastructure sector borrowers need to comply with 5 years MAM, unless ECB is denominated in INR.

MAM in case of Track II to be 10 years irrespective of the amount of ECB.

Key remarks:

The all-in-cost requirement for ECB covered are as under:

• Track I and II: Maximum spread of 450 basis points per annum over the benchmark.

• Track III: Maximum spread of 450 basis points per annum over the prevailing yield of the Government of India securities of corresponding maturity.

Permitted end-use for all ECB – Any end-use other than the following:

• real estate activities;

• purchase of land subject to certain exceptions;

• investing in capital market;

• using proceeds for equity investment;

• in certain cases of Track I and III - Working capital purposes, general corporate purposes, repayment of rupee loans;

• on-lending to other entities with any of the above objectives.

**Convertible instruments**

Indian companies can issue fully and mandatorily convertible debentures, fully and mandatorily convertible preference shares and warrants subject to the pricing guidelines/valuation norms and reporting requirements amongst other requirements as prescribed under Indian exchange control regulations.

The issue price for convertible securities shall not be less than the fair value determined by a SEBI registered Merchant Banker as per any internationally accepted pricing methodology on an arm’s length basis. The conversion price shall be determined
upfront, the same shall not be less than the fair value worked out, at the time of issuance of these instruments.

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 now 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/PIO other than by way of gift or inheritance to be as follows:

- NRI and PIO 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.
  - 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/PIO if acquired out of foreign currency shall be permitted, provided certain conditions are satisfied, inter alia, including the following:

The amount to be repatriated does not exceed:

- the amount paid for acquisition of the immovable property was received in foreign exchange through normal banking channels; or
- the foreign currency equivalent, as on the date of payment, of the amount paid where such payment was made from the funds held in a FCNR(B) account or NRE account for acquisition of the immovable property.
- In case the immovable property in India has been purchased out of housing loans availed\(^5\) and the repayments for such loans are made out of remittances received from abroad through banking channels or by debit to the NRE/FCNR(B) account of such person, such repayments may be treated as equivalent to foreign exchange received

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\(^5\) in terms of Foreign Exchange Management (borrowing and lending in rupees) Regulations, 2000
• In the case of residential property, the repatriation of sale proceeds is restricted to the proceeds from not more than two such properties.

NRIs/PIOs are permitted to remit up to USD 1m per financial year 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.

Acquisition of securities or units by NRI on repatriation basis

NRIs are freely allowed to invest in companies listed on Indian stock exchanges, engaged in construction and development of real estate projects subject to fulfilment of inter alia the following conditions:

• The purchase and sale is done through a designated authorised dealer branch;

• The total holding by any individual NRI or OCI should not exceed five percent of the total paid-up equity capital on a fully diluted basis or should not exceed five percent 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 ten percent 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 ten per cent can be raised to twenty-four per cent if a special resolution to that effect is passed by the General Body of the Indian company;

• Acquisition of securities or units by NRI/OCI directly or indirectly (ie, through company, trust, etc. incorporated outside India but owned and controlled by said NRI/OCI) on non-repatriation basis;

• Investment in capital instruments/units/LLPs/partnership or proprietary firm can be made without any limit. Additionally, investment in units of SEBI registered REITs are also permitted;

Said investment would be deemed to be treated as domestic investments (ie, at par with the resident investor). Accordingly, the above stated conditions (viz. lock in period, pricing guidelines, etc) would not apply in that case

Prohibition of investment in Nidhi Company or a company engaged in agricultural/plantation activities or real estate business or construction of farm houses or dealing in Transfer of Development Rights.

Real estate investment trusts (REITs)

SEBI first introduced the draft REITs Regulations in 2007 for public comments. After extensive interactions by SEBI with various industry participants, it released draft of the REIT regulations in October 2013. After further modifications, REIT regulations were finally enacted on 26 September 2014. Over the years, the regulators partnered with relevant stake-holders in the country including government bodies, investors and real estate developers to bring these regulations in line with globally recognised norms.
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, warehouses, 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 1,000m INR and individually not less than 200m 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 100m 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 REIT to be listed on a recognised stock exchange in India;
- At the time of initial offer, value of the assets owned by REIT should be at least 5,000m INR and the minimum offer size (2,500m INR being the minimum) would depend upon overall post-issue capital;
- The sponsor should hold a minimum of 5% units in the REIT individually and 15% in aggregate at all times;
- Minimum 25% units (on post issue basis) in the REIT 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;
- REIT can invest either directly in or indirectly in real estate assets in India;
- The 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 the REIT should be represented by completed and rent/income generating assets;
• Maximum of 20% of the value of the 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 not permitted.

Regulatory framework
• foreign investment permitted in REITs;

• persons resident outside India, including NRI, have now been permitted to invest in units of REITs;

• sale/transfer/pledge of units 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 the Sponsor, or the Manager, or the 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.

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 received the assent of the President on 25 March 2016. 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;

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\(^6\) Sponsor, Manager, or Investment Manager can be organised in the form of a LLP
• 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 generally subject to a corporate tax rate of 30% (plus applicable surcharge and education cess) on income computed under normal provisions of the Act and rate of 18.5% (plus applicable surcharge and education cess) on adjusted book profits, whichever being higher.

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

Further, in case of an assessee being a company whose turnover or gross receipts is within the prescribed limit (prescribed turnover is less than or equal to 250 INR cr for FY 2016-17), and not claiming any tax incentives, the rate of tax would stand reduced to 25% vis-à-vis 30% (plus applicable surcharge and cess).
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.

**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 characterized 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. Recently, 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**

The CBDT has notified 10 ICDS. The Standards are applicable from Financial Year 2016-2017 and onwards. 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, however same are awaited to be notified.

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8 Circular dated 25 April 2017
9 Notification No 87/2016 dated 29 September 2016
Sale of properties
Sale of properties held as capital assets (i.e., not developed or held with purpose of selling), is taxable as capital gains. Where the property is held for more than 24 months the same is characterised as long-term. In other cases, it is considered as short-term in nature. Long term capital gains are generally taxable at 20% (plus applicable surcharge and education cess) and short term capital gains are taxable at 30% (plus applicable surcharge and education cess).

Valuation of the FMV of the unquoted securities
The FMV of the unquoted equity shares would be equivalent to the modified networth 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, than 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.

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 30% (plus applicable surcharge and education cess).

Further, with effect from the FY 2018-19, no adjustments shall be made in a case where the variation between stamp duty value and the sale consideration is not more than five percent 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)
Where the tax liability of an Indian company, computed in the prescribed manner, is less than 18.5% of the adjusted book profits of the company, tax would be payable on the book profits at rate of 18.5% (plus applicable surcharge and education 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 the Written-down Value (WDV), of the 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 received from the Special Purpose Vehicle (SPV) (interest income) 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.

Further, dividend / share of profit, as the case may be, are exempt from tax as well, in the hands of the REIT.

Gains on transfer of the securities in the SPVs or real estate assets held by the REIT, should be subject to capital gains tax in hands of the REIT as summarised under:

- In case of transfer of securities held by a REIT in a SPV the capital gains arising therefrom, if any, would be taxed at 20% (plus applicable surcharge and education cess), if the securities were held for more than 24 months and 30% (plus applicable surcharge and education cess), if the securities were held for up to 24 months.

- In case of real estate property directly held by the REIT, income arising on its transfer would be chargeable to tax at the rate of 20% (plus applicable surcharge and education cess) where the property is held for more than 24 months. Any other income of the REIT, would be chargeable in hands of REIT at the rate of 30% (plus applicable surcharge and education cess).

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10 The company declaring dividend is liable to pay dividend distribution tax (DDT) at the rate of 15% (on gross basis) plus surcharge at 12% and education cess at 4% on applicable tax and surcharge. In order to further rationalise the taxation regime for REITs, Finance Act, 2016 provided an exemption from the levy of DDT in respect of dividend declared, distributed or paid by the SPV to the REIT, subject to prescribed conditions.

11 Tax implications, where securities are listed on stock exchange in India are not considered.
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%.

Non-resident Investors\(^\text{12}\)

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 education cess).

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, 30% (plus applicable surcharge and education cess) in case Individuals and 40% (plus applicable surcharge and education cess) in case of Corporates.

Tax treatment at investor level

Resident Investors

The income distributed by the REIT, received by it by way of interest or lease rent, could be taxed at a maximum rate of 30% (plus applicable surcharge and education cess). 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.

Transfer of listed units of the REIT would be subject to tax from any transfer made on or after 1 April 2018. Tax implications on capital gains on the sale of the units in the REIT are discussed below:

- Capital gains on transfer of units listed on a recognised stock exchange in India and on which Securities Transaction Tax (STT) is paid, if are held for more than 36 months, would be regarded as long term capital gains and subject to tax at the rate of 10% (plus applicable surcharge and education cess);

- Capital gains on transfer of units listed on a recognised stock exchange in India and on which STT is paid, if are held for up to 36 months, would be regarded as short term capital gains and subject to tax at the rate of 15% (plus applicable surcharge and education cess).

Non-resident investors\(^\text{11}\)

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 education cess).

Lease rent income received by the REIT, distributed to the unit holders, could be taxed at a maximum rate of 30% (plus applicable surcharge and education cess), in the case of individuals and a rate of 40% (plus applicable surcharge and education cess), in the case of corporates.

\(^{12}\) Availability of treaty benefits, if any, has not been considered.
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 18.5% (plus applicable surcharge and education cess) for 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.

In case units are received in exchange for assets, other than shares in an SPV, such a transaction should be chargeable to tax. Where the exchanged assets are held for more than 24 months, the rate of tax is 20% (plus applicable surcharge and education cess), and held for up to 24 months, the rate of tax is 30% (plus applicable surcharge and education cess).

Tax on repatriation to Investor
Repatriation of income on investments by non-resident investors in an Indian company is typically in the form of capital gains, interest and dividend.

Ordinarily, long term capital gains are taxable at 10%-20% (plus applicable surcharge and education cess) whereas short term capital gains are taxable at 15%-40% (plus applicable surcharge and education cess).

Dividend is exempt from tax in the hands of the recipient, the Indian company distributing dividend is subject to Dividend Distribution Tax ('DDT'). However, with effect from 1 June 2016, a special dispensation and exemption from levy of DDT would be as follows:

a) exemption from levy of DDT in respect of distributions made by SPV to REIT;

b) such dividend received by the REIT and its investor shall not be taxable in the hands of REIT or investors;

c) the exemption from levy of DDT would only be in the cases where the REIT either holds 100% of the share capital of the SPV or holds all of the share capital other than that which is required to be held by any other entity as part of any direction of any Government or specific requirement of any law to this effect or which is held by Government or Government bodies; and

d) the exemption from the levy of DDT would only be in respect of dividends paid out of current income after the date when the REIT acquires the shareholding referred in (c) above in the SPV. The dividends paid out of accumulated and current profits upto this date shall be liable for levy of DDT as and when any dividend out of these profits is distributed by the company either to the REIT or any other shareholder.

Interest income received from REITs should be subject to concessional rate of 5% (plus applicable surcharge and education cess).
Transfer pricing
The Indian Transfer Pricing (TP) 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, concept of secondary TP adjustment have been made applicable for primary TP adjustments post 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 harbor 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 w.e.f. 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 10m 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 EBITDA (earnings before interest, taxes, depreciation and amortisation) 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.

Losses carried forward
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, the current year loss of the house property could not be set-off more than 2 INR lacs against other heads of income. 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 tax payer 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)
between India and other countries

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 (‘the 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 would be required to be read in context of the MLI.

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 is India’s biggest tax reform post-independence. Prior to the introduction of GST,
a heterogeneous indirect tax structure existed in India which included levy of taxes by
the Centre and States under different tax laws. Central levies included excise duty on manufacture of goods, central sales tax on inter-state sale of goods and service tax on services rendered and taxes at state level such as value-added tax on local sale of goods in a state, entertainment tax and octroi.

The earlier indirect tax framework had challenges of multiplicity and cascading of taxes, apart from other issues/complexities, both technical as well as from the perspective of ground-level practices.

The GST regime implemented on 1 July 2017, seeks to transform the Indian economy with its ‘One Nation, One Market, One Tax’ principle by subsuming a host of indirect taxes charged at varied rates by the centre and states, therefore bringing uniformity in taxation across the country.

We have provided below an overview of how indirect taxes apply to the real estate sector.

**Goods and services tax (GST)**

From a real estate developer’s standpoint, GST would apply on sale of under-construction properties, i.e., prior to the receipt of Occupancy Certificate from governmental authorities. The GST rate has been pegged at 18% (12% in case of specified affordable housing projects), with a 33% abatement being provided towards the value of the land. Thus, the effective GST rate for sale of under-construction properties is 12%/8% of the agreement value.

It may be noted that GST does not apply on sale or purchase of land or building or on the value of land in any construction project. However, ‘construction of building’, ‘works contracts’, ‘leasing of land or building’ and any other ‘construction-related activities’ have been classified as ‘supply of service’ and are therefore taxable under the GST law. Long term (30+ years) leasing of land for individual purpose from a government functionary is exempt from GST.

The GST law covers the concept of a composite supply which include a supply consisting of two or more goods or services or a combination of goods or services which are naturally bundled and supplied in conjunction with each other in the ordinary course of business. In case of composite supply, the supply is taxed as per the GST rate applicable on the principal supply. The charges recovered by the developer in form of preferential location, car parking, interior construction charges etc are typically treated to be a part of a composite supply in which it is taxed at par with a principal supply is works contract / construction services.

In the real estate context, GST applies on most services rendered such as construction, property management and maintenance, leasing of land, renting on immovable property for commercial purposes, services of real estate agents, architects, etc. However, GST is not applicable on renting of immovable property for a residential dwelling, as such services are specifically exempted.

The GST law allows utilisation of input tax credit (ITC) of GST paid on inputs, input services and capital goods against taxes payable on construction or works contract services provided by developers. However, the GST law restricts ITC of GST paid on (a) goods and services procured for construction of a building which is used for one’s own account and (b) works contract services when used in creation of an immovable property. Accordingly, credit restrictions would apply to commercial constructions developed for leasing/rental purposes or immovable property constructed for self- use
used in the course or furtherance of business. However, credit is allowed on plant and machinery as defined under the GST law. This segregation in some situations may result in debate.

Goods and/or services provided to SEZ developers and SEZ units are zero rated under the GST law. Thus, a person supplying goods and / or services to an SEZ developer or SEZ unit may make such supplies without payment of GST; also, as a consequence of zero rating, such supplier will be entitled to seek a refund of GST paid on items used for supply to the SEZ/ SEZ unit.

It may also be noted that, as a transitionary provision in force for two years, the GST law requires businesses to mandatorily pass on benefits derived from reduction in rate or benefit from input tax credits to its customers. The industry is grappling to determine the actual benefit on account of GST as there is lack of clarity on how the benefit (if any), is to be calculated. The government has been very aggressive, especially with the real estate sector, to investigate businesses for non-compliance under anti-profiteering provisions and had issued the first administrative instruction on this issue for the real estate sector.

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. 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.
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Real Estate
Going Global
Indonesia

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 29 August 2018.
Real Estate Tax Summary – Indonesia

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).

Value-added tax (VAT)

Real estate transactions are also subject to VAT 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 also subject to VAT at 10%.
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 land owner. 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, i.e., 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 (i.e., 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 (i.e., through HGB, HGU, HP, and Hak Sewa – as further explained below). Depending on the selected line of business (i.e., 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 through a PT PMA.

Having said that and given the current policy of foreign investment in Indonesia, we perceive that it will need to be a large-scale and significant real estate development. There is no clear definition of large scale; however noting the amount of minimum investment mentioned below presumably approval for acquiring small land holdings or houses through a PMA company is unlikely.

Foreign companies and individuals, alone or together with Indonesian limited liability companies, individuals and cooperatives, generally need to establish a PT PMA in accordance with Law No.25 of 2007 on Capital Investments (“Investment Law”) to engage in businesses/activities open to direct foreign investment, which will need to be approved by the Capital Investment Coordinating Board (BKPM).

If a foreigner 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 US$714,000.
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, please note that 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, a HGB title may theoretically be renewed for another 30 years.

HGB may be granted to (i) Indonesian citizens, (ii) Indonesian corporate entities established under Indonesian law and domiciled in Indonesia, including PT PMA.

HGB may be acquired by:

- (i) transferring the (existing) HGB from the holder to the transferor, by sale/purchase, exchange or donation;

- (ii) 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 organization 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 25ha (for individuals). For corporate bodies, these sizes will be determined by the Land Office.

HGU may only be granted to:

- Indonesian citizens;
- 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.
This is not a registered land title with the 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).

Unfortunately, Hak Sewa is not a registered land title with the Indonesian Land Office (as it is generally a contractual right over the existing title). 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 with 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 Izin Lokasi (Location Permit)**

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 25ha (for the agriculture business sector), and not more than 1ha (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.

Please note that 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 it currently holds and requests that a new location as 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 permit under the name of the transferee.

Please note that since a location permit is issued by the local government (Municipality/Regency Government/Bupati), there may be local regulations that need to be considered.

**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, e.g., 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. Please note that 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.

**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. Please note that 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 a 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 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, for example property management, will be subject to the normal corporate income tax at a flat rate of 25%.

The corporate tax rate of 25% may be reduced to 20% for listed companies that satisfy all of the following conditions:

- total shares held by the public amount to a minimum of 40% of the total paid in capital;
- total shares are held by at least 300 parties with each holding less than 5% of total paid in capital; and
- the above conditions must prevail for at least six months or 183 calendar days within one fiscal year.

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 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 10 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 5% of the selling price excluding VAT and Luxury Sales Tax:

- houses and land priced at more than 5 billion IDR or building area of more than 400 square metres;
• apartments, condominiums, and similar types of building selling for more than 5 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.

**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 (e.g., 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, town houses of the type of strata title, and those of similar type with a sale price of 10 billion IDR or more, and luxury houses and town houses of non-strata title type with a sale price of 20 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 a maximum rate of 10%.

- **As for non-resident shareholders**, the dividends are subject to withholding tax of 20% (or the applicable reduced treaty rate).
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**Real Estate Tax Summary – Ireland**

**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 or €1m 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.

Relief from CGT is available for properties purchased between 7 December 2011 and 31 December 2014. The relief provides an exemption from CGT where the property is held for at least four years and up to seven years from the time it is acquired.
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:

- 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 includes 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 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 9 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 European Economic Area (EEA) resident company 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 10 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 Azerbaijan, Oman, Turkmenistan and Uruguay. Negotiations have concluded on a Protocol and the existing DTA with 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 20%) 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
- companies 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.

Country-by-Country (CbC) reporting
Groups with consolidated annualised group revenue of €750m 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’ (i.e., 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 (i.e., 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 VAT60B mechanism is used only in limited circumstances.

Details of the current VAT rates are available on page 26 of the most recent edition of PwC’s publication Tax Facts (PwC 2018 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 in the section below under ‘Tax depreciation’.

It should be noted that, in the case of rented residential property, the tax deduction for interest costs is limited to 75% of the actual interest charge incurred and the deduction is also 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 or €1m 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 7 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 is 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, approved retirement funds, approved minimum retirement funds, and vested personal retirement savings accounts.

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.

The legislation was also amended, however, to remove the exemption from IREF withholding tax which currently exists in respect of distributions made out of gains arising on the disposal of Irish land and buildings which have been held by an IREF for a period of at least five years. Furthermore, the exclusion that currently exists in respect of unrealised profits or gains relating to Irish land and buildings booked in the IREF’s accounts is also to be removed.

Please note that these exemptions do not apply to distributions where the IREF is a Personal Portfolio IREF (PPIREF) in respect of its unit holder(s). The exemptions will no longer apply to disposals made on or after 1 January 2019.

**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 10 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.

Duty of 1% applies on the transfer/purchase of residential property where the value of property does not exceed €1m. Where the value of the property exceeds €1m, duty of 2% applies on the excess.

As indicated in Finance Act 2017, the stamp duty rate on transfers of non-residential property has increased from 2% to 6%, in respect of instruments of transfer executed on or after 11 October 2017.

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 2% 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 (e.g. 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. In 2015 the government introduced household water charges for private residences.
Real Estate Investments

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**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 Dublin City Council, Fingal, Dún Laoghaire-Rathdown, South Dublin, Limerick City and County and Waterford City and County.

Revaluation is currently taking place in Kildare, Leitrim, Longford, Offaly, Roscommon, Sligo and Westmeath County Councils. The project is called "Revaluation 2017" as all ratepayers in these areas will receive their final Valuation Certificates in 2017 effective for rates purposes from 2018 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.

In comparison, the rateable value of a property where a revaluation has not yet occurred, eg, Cork City, would be calculated as follows:

<table>
<thead>
<tr>
<th>Estimated rental value</th>
<th>€ 50,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjust by percentage, eg,</td>
<td>0.5%</td>
</tr>
<tr>
<td>Rateable value</td>
<td>€250</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>City</th>
<th>Multiplier (2018)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cork</td>
<td>74.75</td>
</tr>
<tr>
<td>Galway</td>
<td>67.40</td>
</tr>
<tr>
<td>Dublin</td>
<td>0.258</td>
</tr>
<tr>
<td>Limerick</td>
<td>0.2627</td>
</tr>
<tr>
<td>Waterford</td>
<td>0.2583</td>
</tr>
</tbody>
</table>
If, for example, the property was situated in Cork City, the annual rates liability would be calculated as follows (based on the above figures):

<table>
<thead>
<tr>
<th>Rateable value</th>
<th>€250</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiplier applying in 2018</td>
<td>74.75</td>
</tr>
<tr>
<td>Annual rates liability</td>
<td>€18,587.50</td>
</tr>
</tbody>
</table>

If the property was situated in Dublin City, the annual rates liability would be calculated as follows (based on the above figures):

<table>
<thead>
<tr>
<th>Rateable value</th>
<th>€100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Multiplier applying in 2018</td>
<td>0.2580</td>
</tr>
<tr>
<td>Annual rates liability</td>
<td>€25,800</td>
</tr>
</tbody>
</table>

All local authorities are currently being revalued under a National Revaluation Programme. To date, revaluation has been completed in Dublin City Council, Fingal, Dún Laoghaire-Rathdown, South Dublin, Limerick City and County, Waterford City, Kildare, Leitrim, Longford, Offaly, Roscommon, Sligo and Westmeath County Councils. The project is called “Revaluation 2017” as all ratepayers in these areas will receive their final Valuation Certificates in 2017 effective for rates purposes from 2018 onwards.

**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. Bands then go up in multiples of €50,000.
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If a property is valued at €1m or lower, the tax is based on the mid-point of the relevant band. For properties valued over €1m the tax is charged on the balance over €1m. The basic LPT rate was set at 0.18% for properties valued under €1m and 0.25% on the amount of the value over €1m.

<table>
<thead>
<tr>
<th>Valuation band</th>
<th>Mid-point (€)</th>
<th>Standard rate (%)</th>
<th>Standard LPT payment (€)</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 100,000</td>
<td>50,000</td>
<td>0.18</td>
<td>90</td>
</tr>
<tr>
<td>100,001 - 150,000</td>
<td>125,000</td>
<td>0.18</td>
<td>225</td>
</tr>
<tr>
<td>150,001 - 200,000</td>
<td>175,000</td>
<td>0.18</td>
<td>315</td>
</tr>
<tr>
<td>200,001 - 250,000</td>
<td>225,000</td>
<td>0.18</td>
<td>405</td>
</tr>
<tr>
<td>250,001 - 300,000</td>
<td>275,000</td>
<td>0.18</td>
<td>495</td>
</tr>
<tr>
<td>300,001 - 350,000</td>
<td>325,000</td>
<td>0.18</td>
<td>585</td>
</tr>
<tr>
<td>350,001 - 400,000</td>
<td>375,000</td>
<td>0.18</td>
<td>675</td>
</tr>
<tr>
<td>400,001 - 450,000</td>
<td>425,000</td>
<td>0.18</td>
<td>765</td>
</tr>
<tr>
<td>450,001 - 500,000</td>
<td>475,000</td>
<td>0.18</td>
<td>855</td>
</tr>
<tr>
<td>500,001 - 550,000</td>
<td>525,000</td>
<td>0.18</td>
<td>945</td>
</tr>
<tr>
<td>550,001 - 600,000</td>
<td>575,000</td>
<td>0.18</td>
<td>1,035</td>
</tr>
<tr>
<td>600,001 - 650,000</td>
<td>625,000</td>
<td>0.18</td>
<td>1,125</td>
</tr>
<tr>
<td>650,001 - 700,000</td>
<td>675,000</td>
<td>0.18</td>
<td>1,215</td>
</tr>
<tr>
<td>700,001 - 750,000</td>
<td>725,000</td>
<td>0.18</td>
<td>1,305</td>
</tr>
<tr>
<td>750,001 - 800,000</td>
<td>775,000</td>
<td>0.18</td>
<td>1,395</td>
</tr>
<tr>
<td>800,001 - 850,000</td>
<td>825,000</td>
<td>0.18</td>
<td>1,485</td>
</tr>
<tr>
<td>850,001 - 900,000</td>
<td>875,000</td>
<td>0.18</td>
<td>1,575</td>
</tr>
<tr>
<td>900,001 - 950,000</td>
<td>925,000</td>
<td>0.18</td>
<td>1,665</td>
</tr>
<tr>
<td>950,001 - 1,000,000</td>
<td>975,000</td>
<td>0.18</td>
<td>1,755</td>
</tr>
</tbody>
</table>

Properties worth more than €1m are assessed on the actual value at 0.18% on the first €1m and 0.25% on the portion above €1m.

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 2018, Revenue must have been notified of the local adjustment factor on or before 30 September 2017. 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 ATAD comprises five operative components: interest limitation rules, controlled foreign company (CFC) rules, exit tax, general anti-abuse rule (GAAR) and anti-hybrid rules. The ATAD must be transposed into Irish law by 1 January 2019, with the exception of the interest limitation rules (1 January 2024) and the exit tax (1 January 2020).
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All information used in this content, unless otherwise stated, is up to date as of 17 September 2018.
Real Estate Tax Summary – Israel

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, e.g. insurance, maintenance, property management. A withholding tax (WHT) of 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 2017, 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 (2017), regular profits of 100 for an Israeli company will provide a net, ie, after tax, dividend income of 53.9 (57.25 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 30% to 47% for passive rental income. In addition, individuals are taxed at rates of 10% to 48% 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 ILS 5,010). 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 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%;
- other buildings - 4%.

The above rates apply to the assets of an entity that adjusts its income statement according to the inflationary tax adjustment rules, or which elects to keep books of account on a US dollar basis, where this is permissible. 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 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% (2016).
  - 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.

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 fulfillment 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 10 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:

<table>
<thead>
<tr>
<th>Type of Property</th>
<th>Transfer Fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regular rate</td>
<td>6%</td>
</tr>
<tr>
<td>Apartment/house intended for residential use</td>
<td>0%</td>
</tr>
<tr>
<td>first and only home</td>
<td>0%</td>
</tr>
<tr>
<td>and exceeding the amount of 1,623,320 ILS</td>
<td>3.5% to 10%</td>
</tr>
<tr>
<td>additional home</td>
<td>8% to 10%</td>
</tr>
</tbody>
</table>
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
Going Global
Italy

Tax and legal aspects of real estate investments around the globe
2018
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All information used in this content, unless otherwise stated, is up to date as of 31 July 2018.
Real Estate Tax Summary – Italy

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 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 relevant 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 investment, depending on the nature of the investor, 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 of aggregated taxable income), and to local surcharges (up to 4.23%);
  - For residential buildings leased out, a favourable substitute tax regime (cedolare secca), alternative to the ordinary taxation, is provided; the substitute tax applies with rate of 21% (15% in some circumstances - reduced to 10% for FYs 2014-2019) on the rents;
  - Local property tax (IMU) is due; it is not tax deductible, but it replaces income taxes in 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%¹ (27.5% until 2016); the taxable base is the same ordinarily stated for individuals.

- Local property tax (IMU) is due and it is not tax deductible (except for a portion in specific circumstances for IRES purpose).

**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 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 corporate income tax (IRES) and to regional tax on production (IRAP), with the exception of sale of an ongoing 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 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 corporate income tax (IRES), with rate of 24% (27.5% until 2016), and to regional tax on production (IRAP), with ordinary 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.

¹ for companies with tax period corresponding to the calendar year; For companies with tax period not corresponding to the calendar year, the reduced tax rate will apply from the tax period starting from 1 July 2017.
• 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 (based on the 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 case of instrumental properties (ie, offices, retail areas, etc) 20% of local property tax paid can be deducted for IRES purposes.

• 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 making reference to the actual proceeds and to systematic loss position.

Indirect taxes

Regardless the structure of the investment, 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 Italian real estate industry, such as:

• investment into units of an Italian Real Estate Investment Fund (Fondo Comune di Investimento Immobiliare), contractual closed-end investment fund;

• investment into shares of an Italian SICAF (Società di Investimento a Capitale Fisso), corporate closed-end 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 – Italy**

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 do not make real estate investments directly, but through a special purpose vehicle (SPV), 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 Italy (by way of example and without limitation: Afghanistan, Bahamas, Congo, Liberia, Iraq, Madagascar and Myanmar).

Useful information to check if the “reciprocity principle” is met or not, may be found on the website on the Italian Ministry of Foreign Affairs where a country list is posted (http://www.esteri.it/MAE/IT/Ministero/Servizi/Stranieri/Elenco_Paesi.htm). Please bear in mind that the information is available only in Italian.

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 liable 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 tax – Taxation of individuals**

In Italy, individuals are subject to IRPEF (*Imposta sul Reddito delle Persone Fisiche*, the income tax for individuals).

**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. 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% (15% in particular circumstances - reduced to 10% for FYs 2014-2019) 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 tax – 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 corporate income tax (IRES) and to regional tax on production (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 corporate income tax (IRES), levied at the rate of 24% from 2017 (previously 27.5%).

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 (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 building, the cadastral income, revalued 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, revalued 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 case of instrumental buildings, the local property tax (IMU) paid is 20% deductible.

The IRES taxable base can be reduced through deduction of 10% of the IRAP (the regional tax on production) paid out during the year, in case the company has interest expenses and labour costs which are IRAP not deductible, and through the deduction of IRAP referable to the taxed portion of labour costs (ie, net of allowances deductions).
With effect from 2015, companies without employees can benefit from a tax credit, to be used to offset all kind of taxes, equal to 10% of the annual IRAP liability. Such credit gives rise to an income which is taxable for IRES purpose.

The Allowance for Equity Increase (*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, 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 rate resolved for the relevant tax period. The ACE rate is linked to the Italian government bonds rates, increased by up to 3%. In particular, ACE has been computed with rate of 3% from 2011 to 2013, 4% for 2014, 4.5% for 2015, 4.75% for 2016 and 1.6% for 2017. From 2018, the ACE rate has been set at 1.5%. The notional amount exceeding the taxable income of a year can be carried forward to increase the amount deductible from 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) 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’ EBITDA. Interest expenses exceeding the ‘rectified’ EBITDA and unused ‘rectified’ EBITDA may 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 30% EBITDA of the same years.

It is worth noting that, in 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.

With regard to the determination of the EBITDA, reference should be made to the income statement of the company (taking into consideration that rentals paid in respect of financial leasing contracts concerning instrumental assets are excluded, as well as depreciations of assets).

This 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.
Mitigation of the interest expenses non-deductibility is possible under the domestic tax group regime, if and to the extent that other companies participating to the tax group have unused EBITDA against which the excess of interest expense 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).

It is worth noting that, with effects from 2019, the Italian tax system will have to implement the Anti-Tax Avoidance Directive (ATAD) - EU Directive No 1164/2016. With particular reference to interest expenses, some of the current provisions (eg, the above mentioned exception for the mortgage financing, the rules of quantification of the relevant EBITDA, etc) do not comply with the provisions of article 4 of the Directive. As a result, some important changes to the current rules are expected.

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).

The above summarised 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% is applicable.

Tax losses carryforward
For corporate income tax (IRES), tax loss carryforward is admitted. Conversely, the regional tax on production (IRAP) system does not allow 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, in case tax losses of the first three years are not available, must be taxed at the ordinary IRES rate.

The loss carryforward is forbidden in 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 (i.e., (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 5-year period it generates tax losses for 4 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 (i.e., the tax return regarding the tax period interested by the discipline). Ruling are 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, a 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:

\[
\text{Value of production} = \text{Gross proceeds from sales and services} + \text{Variations in inventory and work in progress} + \text{Other non-financial incomes} - \text{Cost of raw and other materials} - \text{Cost of services (administrative costs)} - \text{Depreciation of tangible and intangible assets} - \text{Other operating expenses}
\]

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.

With effect from 2015, companies without employees can benefit from a tax credit, to be used to offset all kind of taxes, equal to 10% of the annual IRAP liability. Such credit gives rise to an income which is taxable for IRES purpose.

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 corporate income tax (IRES), levied at a 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.
- 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 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 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.

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 (e.g., residential buildings having certain requirements; buildings, even under construction, sold by builders, certain restructuring works, etc).

With regard to the territoriality requirement for real estate-connected services and operations, effective from 1st January 2017, a new UE 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 property, 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) 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 the case of lessor’s 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 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 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). 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, 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%. In case the land should not be qualified neither as agricultural nor as buildable land at the moment of the transfer (ie, parking area), it should be subject to proportional registration at 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 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 9 years are also subject to fixed nominal mortgage tax (€200). 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 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 case of lease of buildings for housing made by individuals, the substitute tax regime (cedolare secco) provided for the lessor for income tax purposes replaces also registration tax on rentals (see section ‘Income tax – 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 if leased by a VAT entity (so subject to VAT).

For financial leasing contracts, starting from the 1 January 2011:

- for contracts drawn up by a public deed or by an authenticated/notarised private deed, registration tax is due in fixed amount of €200 (as consequence of the alternation VAT-registration tax);

- for contracts drawn up by a private deed (non-notarised) registration tax is due (in fixed amount of €200) only in 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) 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 after purchase 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 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 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 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.
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 regards 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 cuìus’ in the case of inheritance; the donor in the case of gift) and the transferee subject (ie, the heir, for inheritance; the donee for 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 €1m (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 (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 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

Unified Municipal Tax (IUC)

Effective since 2014, the main municipal taxes related to real estate properties have been encased under the single definition of IUC, the Unified Municipal Tax.

This tax is composed of the following three components:

- Municipal Property Tax (IMU);
- Municipal Tax for Indivisible Services (TASI); and
- Municipal Waste Tax (TARI).

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.

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.

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 0.76% for properties (excluding residential properties held by individuals as their main home). However, Municipalities can increase or reduce the standard rate by 0.3%.

IMU is not deductible for the purpose of income taxes for individuals (IRPEF), and, for corporate bodies, in case of instrumental buildings, it is 20% deductible for IRES purpose (not for IRAP purpose).

Municipal Tax for Indivisible Services (TASI)
TASI is the local tax introduced in 2014 to finance certain general services provided by the Municipality (eg, lighting, road maintenance, etc).

The tax is due by the owner (with the partial exception referred below) of real estate properties.

TASI has the same taxable base of IMU (see above).

The TASI ordinary rate is 0.1%. This rate can be varied by the competent Municipality, taking however into consideration that the aggregate rate of IMU and TASI cannot exceed the maximum IMU rate stated by law, which, for instrumental buildings, is 1.06% (however, until 2018 the TASI rate can be increased to 0.33% and the 1.06% cap can be increased to 1.14%).

In case of leased properties, TASI is partially due by the tenant, in the range from 10% to 30%, according to the percentage determined by the competent Municipality. The owner is not liable regarding the amount due by the tenant.

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 tax – 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 case of listed company and 20% of the voting rights or 25% of the capital in 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 withholding tax 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 non-qualified participations into companies, partnerships and other bodies, are subject to a substitute tax at a rate of 26%; capital losses, other than those concerning qualified participations, can reduce the taxable base, under terms and limits stated by the law. Conversely, capital gains realised on disposal of qualified participations are 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. However, from 1 January 2019, these capital gains will be all subject to the 26% substitute tax.

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/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, but up to eleven/twenty-sixth of such Italian WHT (i.e., max 11%). The payment of the foreign taxes has to be certified by the competent foreign tax authority.

Reimbursement should be not 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 the section ‘Residents 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 tax – Taxation of corporate entities**

**Resident companies**

For corporate income tax (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 White List for which a positive ruling is not obtained; (ii) foreign source 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 for 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/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 regional tax on production (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 source dividends are subject to a 26% domestic WHT, levied at source as definitive payment. However, according to domestic rules, non-resident entities can claim for a refund of part of the Italian WHT suffered, for the amount of taxes they have paid abroad on the same income, up to eleven/twenty-sixth of such Italian WHT. The payment of the foreign taxes has to be certified by the competent foreign tax authority. Reimbursement should be not 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 EEC Directive no. 90/435, the Parent-Subsidiary Directive, to the extent that all conditions are met.

For dividends paid out to corporations and other entities subject to income tax and resident in an EU Member State or in a state 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 tax rate is 24% - 27.5% until 2016 – IRES rate).

Indirect taxes
Transfers of shares or quotas of Italian companies are VAT-exempt transactions (ie, falling in the scope of VAT, but zero-rated) and are subject to registration tax at a fixed amount (€200) 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 case of private deed, registration tax is due, at a fixed amount (€200), only in 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. (Join 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 fully 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.

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 2% 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 applicable 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 (i.e., registration tax, mortgage tax, stamp duty). However, for loan agreements entered into by exchange of correspondence, indirect taxes are due only in case of voluntary registration, or ‘caso d’uso’ (i.e., 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 (i.e., 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. By way of Italian Constitutional Court’s sentence, this option has been recently 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 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 corporate income tax (IRES) purposes, but not for the purpose of the regional tax on production (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 ‘Black List’ 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 Interest-Royalties EU Directive (ie, Directive No 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;
- 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 themselves 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:
• lease for private purpose (expressly provided by Law 392/78); and

• 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 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 a second type of lease agreement for private purpose, 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.

**Lease for commercial purpose**

Lease agreements for commercial purposes are expressly regulated by Law 392/78.

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 when the destination of use is industrial, commercial, handcraft work, tourist interest) or nine years (in the case of hotel management) 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. Independent from 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 when the destination of use is for industrial purposes, and every nine years in the case of hotel management, 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 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 within the lease agreement the landlord’s waive to exercise the right set forth by section 29 at 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%.

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 where 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 communication.

Redemption right
According to section 39 of Law 392/78, in case 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 management, the indemnity is equal to 21 monthly instalments.

Energetic certification
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, paragraph 1, 1-bis, 1-ter and 1-quater of Legislative Decree No 192/2005.

**Tax aspects**

**Income tax**

See sections of ‘Direct investment in Italian real estate property’.

**Indirect taxes**

See sections of ‘Direct investment in Italian real estate property’.

**Financial leasing contract**

**Legal aspects**

The financial leasing agreement is a contract that is not ruled by the law and 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.

Notwithstanding the lack of an acknowledgement by the Italian regulations of an autonomous identity to the leasing agreement, it is worth noting that its development and wide use in recent 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.

Subject to the above, the financial leasing agreement must be drawn up in written form. It is also necessary that the transcription of the term of the agreement is 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’). 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 building.

On the other side, the principal duties of the lessor are: (i) sign the sale and purchase agreement with the vendor of the building chosen by the lessee, (ii) identify with the lessee the delivery T&C of the building, (iii) grant an option right to the lessee for the final purchase of the building.

The main contractual clauses, suitable to be applied in conformity 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**

The amount of the leasing rent is calculated on the basis of the value of the leased building, the length of the lease and the applicable interest rate. 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 building to the leasing company.

**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 building without the lessor’s approval.

**Damages to the immovable**
Generally, in the event of damage or destruction of the building, 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 lease company an immovable (or movable) asset, which is used in the course of its business. Simultaneously, the lease 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).
**Real Estate Going Global – Italy**

**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. 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 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 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).
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 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.

In case 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.

**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 case 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 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 in exchange for 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 fixed 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 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 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) application of land and buildings registration of the real estate property; (ii) written declaration issued by the installing company of the property’s equipment attesting their compliance with the applicable law provisions to be 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. To this regard, please note that the Italian Civil Code expressly provides for the seller’s obligation to deliver all the documents and certificates pertaining to the ownership and use of the real estate property at the time of the execution of the deed of transfer. 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 to €464.

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 share 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 energy certificate shall be released, at the end of the works, by the builder and duly approved by the director of the works. Such certificate 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 Law Decree No 63 issued on 4 June 2013, passed 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 to €18,000. The payment of such sanction does not free the parties from the obligation to deliver or attach the relevant certificate within a maximum 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 specified 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.

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
‘caparra confirmatoria’ is usually paid at the time of the 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 (Rogito)

The last step in acquiring a property is the signing of a definitive sale and purchase agreement. This deed is signed before a public notary and it has to be considered the legal instrument that determines the concrete transfer of the property from the seller to the purchaser.

Prior to the signature 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 rogito) 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 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 20% 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% (instead of 27.5% from 2017) 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).

When a real estate property is part of a transferred business (azienda), or an ongoing 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 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).

Upon seller’s option (to be expressed in the sale and purchase deed) the taxable capital gain may be subject to a 20% substitute tax instead of taxation in the annual income tax return (this option is not admitted for capital gains on disposal of buildable lands).

**Indirect taxes**

The preliminary agreement concerning the intended transfer of real estate properties is subject to fixed registration tax of €200 (and to an additional fixed mortgage tax of
In case 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 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%.

For more details, see section ‘Direct investment in Italian real estate property’.

Real estate investment funds

Investment funds are ‘instruments’ for collective portfolio 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 pertaining to a plurality of investors; collectively managed by an SGR (an authorised regulated management company) in the interest of the participants, but autonomously from them.

In respect of previous definitions, the following requirements have been introduced/emphasised:

- collection of wealth from a plurality of investors;
- existence of investment programs defined in advance;
- management of the fund independent from participants.

An Italian collective investment fund, which has contractual origin, may be set up in the form of:

- an open-ended fund, in which the participants can redeem at any time their units, according to the rules provided by the fund’s regulations;
- a closed-end fund, in which the participants’ redemption right may be exercised only at predetermined maturities.

Further to the implementation of the Alternative Investment Fund Managers Directive (Directive No 2011/61/UE, 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. In its turn, the OICR is defined as “an undertaking established to provide the financial service of investment and management of savings on a collective basis, whose assets are raised among a plurality of investors by means of issuing or offer of shares and units, managed on a collective basis in the interests of the investors and autonomously from the same, and invested in financial instruments, receivables, including those granted
to non-consumer, on funds’ assets, interest and other transferable and immovable assets, in accordance with a predetermined investment strategy”.

The management of investment funds represents a ‘collective portfolio management’ activity, which is an investment service that is exercised on a public basis 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.

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 participants. 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).

The REIF is set up as a closed-end fund. It is established by a resolution of the SGR, which also approves the rules 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 one-third of the total fund’s assets (exceptions to this limit exist). The specifics of these limitations may also vary based on the type of fund, potentially more flexible for reserved and speculative funds.

**Tax regime**

The tax regime of Italian real estate investment funds (REIFs) is provided for by Law Decree No351 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 Law Decree 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 (Corporate Income Tax, or IRES - and Regional Tax on Production, 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 deriving from investments in foreign funds).

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 Treaties application.
Law Decree 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 collective investment of savings (i.e., Organismi d’Investimento Collettivo del Risparmio, or Italian OICR);

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 (i.e., 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.

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 – e.g., an indirect control on 60% of a Luxembourg SPV through 90% of a US corporation, equates to 54% actual control on the Lux SPV).

Non-institutional REIFs are those also owned by other kinds of subjects.

**Institutional REIFs – Taxation of investors**

REIF profits are taxed upon distribution, by way of a 26% withholding tax at source (as account payment for investors generating business income; as final payment for all the others).
Italian pension funds and undertakings for collective investment of savings (OICRs) are exempt from the 26% withholding tax.

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% withholding tax on REIF profit distributions:

a) foreign pension funds and foreign undertakings for collective investment of savings (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 case of indirect investment; however, investments through a fully owned corporate SPV resident in a white list country entitle for the exemption.

Non-institutional REIFs – Taxation of investors

Investors 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, 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 withholding tax. 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 withholding tax, according to the same rules applicable to institutional REIFs (treaty reliefs are applicable as well).

The transfer of REIF units is assimilated to disposal of Italian partnerships interest.

**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 real estate investment funds of a 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 purchasers, or as sellers).

Capital gains realised upon contribution 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 31.4%), if the aforesaid assets are held by the REIF for at least three years. 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 SICAF (Società di Investimento a Capitale Fisso) is a new regulated investment vehicle introduced in 2014, by Legislative Decree No 44 dated 4 March, 2014, with the implementation of the AIFMD.

From a legal-regulatory perspective, the SICAF is a closed-end OICR (ie, undertaking for collective investment of savings), set up in the form of company limited by shares with fixed equity and with 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. The SICAF is subject to the regulation and supervision of the same; as a result, the SICAF is obliged to fulfil several requirements (eg, minimum amount of equity, compliance with the ‘regulatory capital’, professional requirements in the hands of the management) and the respect of 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 AIFM). However, as the SICAF is a share company, the investors may influence the management of the OICR, more than investors in the REIF do, 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 the relative section above) applies also to the SICAF, with the sole exception that the SICAF is liable to IRAP (the Regional Tax on Production): for this purpose, the IRAP taxable base is substantially determined by the difference between commission revenues and commission expenses (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) is the Italian version of the better known REIT in force in other countries. 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 Law Decree 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 (S.p.A.s), which are Italian resident for tax purposes, provided that the following conditions are met:

- The shares of the company - whose “prevalent” business is real estate lease activity - shall be listed on the regulated stock exchanges of the European Union or the European Economic Area Member States, included in the so-called 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 at least 25% of the SIIQ 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.

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 Law Decree 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 Law Decree 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 taken into account 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 a 26% withholding tax at source (for non-Italian investors, resident in Countries which have entered into a Treaty against the double taxation with Italy, the withholding tax rate may be reduced under the terms and conditions of the relevant Treaty). Withholding tax is not applied to distributions to: SIIQs, Italian pension funds, Italian OICRs (ie, undertakings for collective investment of savings: eg, UCITs, 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 Law Decree No 133/2014) profits distributed by qualified REIFs. Pursuant to Law Decree 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.

SIIQ status may also be extended to Italian resident non-listed companies performing the lease business as their “prevalent” business (ie, SIINQs), provided that 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 can also be applied by Italian permanent establishments (PE) of companies resident in the countries of the European Union or of the European Economic Area included in the Italian White List, to the extent that such PEs carry out real estate lease activity as their prevalent business. In this case, the PE is subject to a 20% substitute tax.

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 - payable up to 5 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 held by the SIIQ for at least three years.
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Real Estate Going Global

Japan

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 24 July 2018.
Real Estate Tax Summary – Japan

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 varies depending on the year of loss but, pursuant to the recent tax reforms, the carryforward period was extended from nine years to ten years for losses incurred on or after fiscal years beginning on or after 1 April 2018.

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 8%.
Real Estate Investments – Japan

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, i.e., 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 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 24.22% (including national local corporate tax) for fiscal years beginning between 1 April 2018 and 30 September 2019, and 25.59% (including national local corporate tax) after fiscal years beginning on or after 1 October 2019 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 and fixed assets should be depreciated using the straight-line method. Depreciation rates are prescribed by ministerial ordinance.

Fixed assets acquired on or after 1 April 2007 may be fully depreciated, based on their useful life until their remainder value is the equivalent of 1 JPY.

For fixed assets acquired on or before 31 March 2007, old depreciation rules will apply until the asset has been depreciated down to the residual value (5% of the original cost), at which time such residual value may be depreciated using the straight-line method for an additional fiscal period of five years.

For structures and attachments to buildings acquired on or after 1 April 2016, the declining balance method is no longer allowed.

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 24.22% (including national local corporate tax) for fiscal years beginning between 1 April 2018 and 30 September 2019, and 25.59% for fiscal years beginning on or after 1 October 2019.

*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 2020.
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 24.22% (including national local corporate tax) for fiscal years beginning between 1 April 2018 and 30 September 2019 and 25.59% (including national local corporate tax) after fiscal years beginning on or after 1 October 2019, and will need to file a tax return in Japan.

Loss carryforward

In the past, losses could be carried forward for seven years for corporate tax purposes, 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.

Currently, tax losses can be carried forward for ten years. Also, 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 100m JPY and not wholly owned by a corporation with capital of 500m 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 interest

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 2019 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, i.e., 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 2019 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 2019 (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 2020), 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 8% (it is scheduled to increase to 10% from 1 October 2019) 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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Real Estate
Going Global
Latvia

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 26 July 2018.
Real Estate Tax Summary – Latvia

Rental income

Individuals
Individuals earning Latvian-source 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.

From 1 January 2018, the Latvian tax reform came in force abolishing traditional annual corporate income tax (CIT) on profits. Overall, 20% tax will be payable only upon the distribution of financial profits, while re-invested profits will be CIT-exempt.

The new CIT rate is 20% of the taxable base. However, before applying the statutory rate to the taxable base arising from deemed profit distribution for the tax period, this should be divided by the coefficient 0.8. As the taxable base is increased, the effective rate will be 25%.

Both Latvian entities and foreign entities carrying out activities in Latvia through a permanent establishment (PE) are 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 carry forward
The tax loss concept and, consequently, the tax loss carry forward are abolished with the new tax reform. However, transitional rules provides for the five-year period, whereas tax losses incurred up to the 31 December 2017 may be used to reduce the tax payable on dividends upon its distribution from the profits arising after 1 January 2018. As such, newly registered companies will not be 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 a 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 paying income to a non-resident individual. Otherwise, 3% should be withheld 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 constitutes CIT 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 in the real estate company, if the real estate company shares are owned during 36 months prior the disposal.

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, 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. A 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*

Withholding does not apply to dividends paid by a Latvian company. However, the standard CIT rate of 20% of the taxable base (dividends divided by the coefficient 0.8) is applied to the distribution of dividends.
Real estate tax

Municipalities calculate the real estate tax charge and notify the taxpayer by sending a calculation and payment schedule. Real estate tax is levied at the general rate of 1.5% of the cadastral value of land, buildings and structures, while lower rates are applicable for residential buildings:

- 0.2% of the cadastral value of property that does not exceed €56,915;
- 0.4% of the cadastral value of property that is in the range from €56,915 to €106,715;
- 0.6% of the cadastral value of property that exceeds €106,715.

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 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 calculated as a percentage of the transaction value or cadastral (registered) value, whichever is higher.

Value-added tax (VAT)

Leases

A Latvian company or individual must register for VAT purposes if making taxable supplies in excess of €40,000 in any given 12-month period. If within a 12-month period, only one taxable supply is made and this supply exceeds €40,000, the registration for VAT purposes is not mandatory, provided that other taxable transactions will not exceed the total value of €40,000 within a 12-month period. With respect to real estate, supplies could be taxable or 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
The sale of land and other real estate is VAT-exempt, with the exception of sales of unfinished buildings and the first sale of newly built or refurbished buildings.

Sales of unfinished buildings and the first sale of newly erected buildings are subject to 21% VAT on the selling price.

‘Refurbishment’ is defined as work that considerably improves the quality of a building or prolongs its useful life. Mere redecoration or minor repairs do not qualify as refurbishment. If a refurbished building is sold for the first time, VAT is due on the capital gain only, ie, the difference between the selling price and the value of the property prior to refurbishment. Otherwise, VAT is applied to the sale proceeds of the asset.

A ‘newly built or refurbished building’ is defined in Latvian VAT law as follows:

- a newly erected building, which is unused after its erection;
- a newly erected building sold within one year of the date on which the first user took possession;
- a refurbished building which is unused after its erection;
- a refurbished building sold within one year after completion of the refurbishment; or
- an incomplete building.

Recovery of input VAT
Input VAT incurred upon development or refurbishment of buildings is recoverable if the buildings are used to generate taxable supplies. If the building, whether erected or reconstructed, is sold within the period of one to ten years of completion, the sale is exempt from VAT. In this case, a portion of the previously recovered input VAT has to be repaid to the revenue authorities. The repayable amount is calculated as 10% of the recovered input VAT times the number of full years left until the end of the said ten-year period. This amount should be factored into the selling price of the building, but there is no opportunity for the purchaser to deduct it.

Latvia has introduced an option to tax provisions in respect of VAT on real estate transactions.
Real Estate Investments – Latvia

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 company – Sabiedrība ar ierobežotu atbildību (SIA) – or a public limited company – Akciju sabiedrība (AS). In most instances, a foreign investor will consider to set 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 permanent establishment (PE) in Latvia. The taxation regime applicable to a PE is quite similar to that applicable to a limited company SIA. However, the main advantage of investing directly is that capital gains realised by foreign investors might not be taxed in Latvia, unless they are attributable to a PE.

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 taxes

Generally, the following payments made by Latvian companies to non-resident companies are liable to withholding tax at the following rates:

- payments for consulting and management services – 20%;
- payments for the disposal of real estate – 3% (in case the purchaser is a Latvian registered company);
- payments for the disposal of shares in any company if more than 50% of its asset value is real estate located in Latvia – 3%;
- all payments, including dividend payments to non-resident companies which are located in the blacklisted jurisdictions, ie, low tax or no tax jurisdictions – 20%.

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% withholding tax 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 CIT 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 CIT 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 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 company’s interest expenses are less than €3m 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 with the new CIT reform.

If loans are taken for the purpose of construction or development, the interest paid before the completion of the building can be capitalised and added to the cost of the asset, but cannot be depreciated.

**Equity**

The minimum share capital of a private company is €2,800, which must be contributed either in cash or in kind. There is the possibility to register an entity with lower share capital if certain criteria are complied with.
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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Lithuania

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. This criteria means, that a person shall originate from the country which is a member of European Union, NATO, 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 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 500ha), 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 Lithuania¹ this restriction shall be applicable and for the companies set up in Lithuania by the abovementioned restricted persons as well. 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 – also approval from the National Land Service for the lease of the land is 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

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.
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) on gross income.

Withholding tax

Certain income sourced in Lithuania and received by a foreign entity otherwise than through its permanent establishments 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 a rate of 15%.

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 a rate of 15%. Certain exemptions may be applied to capital gains derived by Lithuanian resident holding companies or permanent establishments of foreign companies. For more detailed information, please see below.

For local and foreign individuals capital gain on sale of real estate located in Lithuania generally is subject to 15% PIT.

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 carry forward

Losses from operating activities can be carried forward for an indefinite period of time. Losses incurred from disposal of securities can be offset with the income of the same nature and can be carried forward for the period of five years. However, losses carried forward cannot offset more than 70% of taxable income of the entity in any tax period.

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 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, i.e., 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 – Lithuania

Acquisition and sale of real estate

Tax implications
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:

- notary fees vary from 0.45% on the value of real estate; however, the fees shall not be less than €28.96 or exceed €5,792.40 for one transaction;
- state duties imposed upon the registration of a transfer of real estate are typically not material and vary depending on the real estate value (up to €1,448,10).

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 (ii) the price of shares exceeds €14,500. Notary fees vary from 0.4% to 0.5 % on the value of sale-purchase agreement value; however, the fees shall not be less than €14.48 or exceed €5,792.40 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 taxes’.

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 member state or in other countries with which Lithuania has a double tax treaty.
• 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 taxes**

Generally, income of a foreign entity in Lithuania not derived through a PE is deemed 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 (tantiems) 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 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 paid by a Lithuanian company to a foreign company is subject to withholding tax at a rate of 10%.
However, interest paid from Lithuanian companies to foreign companies established in the European Economic Area 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 (VAT)**

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 European Union, the European Investment Bank, the European Central Bank, even if these legal persons are neither VAT-registered nor do they perform economic 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.

**Reverse-charge regarding construction services**

In Lithuania local VAT reverse-charge mechanism applies for 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 to the Lithuanian taxable person VAT payer by a foreign entity, then the foreign entity would be required to register with 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. Tax is levied on the capital gains, i.e. 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 for investment in real estate. Investment income received by these undertakings are not subject to corporate income tax, however, quite strict requirements has 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 implications

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 must be concluded in written form. When real estate is acquired directly (asset deal), such agreement 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 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 privatization. Most common way of state owned properties privatization 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.

Following recent land regulations some specified restrictions regarding sale of agricultural 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 can own up to 300 hectares of state agricultural land.

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 have pre-emptive rights to buy the agricultural land.

Concentration
Competition Council shall be notified and permission is required when the general income of enterprises concerned is more than €20m for the financial year before concentration and the general income of each of at least two enterprises concerned is more than €2m 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

\(^2\) 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).
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 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.

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 more risky 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. 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 objects of real estate, comprising the investment portfolio of the collective investment undertaking are evaluated by at least two independent qualified property appraisers. In case when all investors are professionals, one appraiser is enough.

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

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 notarized 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 (i.e. companies' profit is taxed).

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 (i.e. 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 double tax treaty 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 are 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. 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 (VAT)**

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 economic activities. From 2012, VAT may be charged on rent of real estate to legal persons established under diplomatic and consular arrangement or to institutions of the European Union, the EIB, the EIC, even if these legal persons are neither VAT-registered nor do they perform economic 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 contract 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 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.

**Losses carried forward**

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**

Real estate tax (RET) applies on buildings/premises owned by companies and individuals. The tax rate may vary from 0.3% to 3% depending on municipalities.

In Vilnius, the RET rates established for 2018 are:

- 1% - standard RET rate;
- 0.7% - for cultural, leisure, catering, sport, educational or hotel buildings (with some exceptions);
- 3% - for actually used real estate, that is not 100 percent completed and for real estate that is not used at all or is abandoned or unattended.

Residential and other personal premises owned by individuals are exempt from tax where the total value of €220,000 is not exceeded, whereas the excess value is subject to progressive taxation:

- 0.5% RET rate is applied on taxable value exceeding €220,000 but not exceeding €300,000;
- 1% RET rate is applied on taxable value exceeding €300,000 but not exceeding €500,000;
- 2% RET rate is applied on taxable value exceeding €500,000.

Total non-taxable value is increased by 30% to real estate held by families which meet certain criteria. 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 market 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, the Land tax rates established for 2018 are:

- 0.08% - tax rate for individuals;
- 0.12% - tax rate for companies;
- 4% - for the land that is not used and for the land with buildings recognised as unauthorised construction.

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 market 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 rate is 4% of the value of the land. The actual rate is established by the relevant municipality council.

**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 (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) and 10% (if the taxable value exceeds €150,000).

Inheritance tax is not imposed if the taxable value of the inherited property does not exceed €3,000, 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 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).

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.

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 €2.9 million, as well as all banks, insurance companies and credit institutions are required to prepare transfer pricing documentation in a specifically prescribed form. As from 1 January 2017, 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 €1,400 to €4,300.

Withholding tax
Certain income sourced in Lithuania and received by a foreign entity otherwise than through its permanent establishments in Lithuania is subject to WHT.
Interest paid from Lithuanian companies to foreign companies established in the European Economic Area 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 a 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, including:

- rules on taxation of controlled foreign corporations;
- rules on taxation of dividends receivable/payable from/to foreign companies;
- substance over the form principle.

**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.

**General anti-avoidance rules (GAAR)**

**Pending corporate income tax amendment**

According to the draft of Law on CIT, following EU Anti-Tax avoidance Directive (ATAD) as from 1 January 2019, the new anti-avoidance rule will be introduced in Lithuania. According to the new rule, when calculating the corporate income tax, certain structure or several structures, whose purpose or one of the main objectives is to obtain tax benefits that is in conflict with the object or purpose of the Law on CIT are to be ignored/excluded. Therefore, these structures are presumed to be artificial, taking into account all relevant facts and circumstances. A structure or several structures are considered artificial if they have not been incorporated for important commercial reasons reflecting economic reality. Therefore, in the light of these new Law on CIT provisions, the Lithuanian Tax Administrator will have the right to eliminate artificial elements from group structures for tax calculation purposes.
Interest deductibility rules

Following EU ATAD, the new interest deductibility regulations are planned to be adopted and applied in Lithuania as of 1 January 2019.

According to the draft law, exceeding borrowing costs shall be deductible in the tax period in which they are incurred only up to 30% of the taxpayer's taxable EBITDA.

Exceeding borrowing costs are calculated as the amount by which the borrowing costs of a taxpayer exceed interest revenues (i.e., interest income minus interest expenses). Interest includes interest on all forms of debt (from related as well unrelated parties), including:

- 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; and
- other costs/income economically equivalent to interest and incurred in connection with the raising of finance.

The company in Lithuania is given the right to deduct exceeding borrowing costs up to €500,000 (de minimis threshold). This amount shall be considered for all the entities in Lithuania that belong to the same group.

Where the entity exceeds 30% of taxable EBITDA rule, an additional possibility is provided to calculate the group’s ratio of third party borrowing costs to group’s taxable EBITDA (where it is higher than 30%). This rule may be applied only where the Lithuanian company is a member of a consolidated group for financial accounting purposes according to Lithuanian laws.

The group ratio should be determined by dividing the exceeding borrowing costs of the group vis-à-vis third-parties over the taxable EBITDA of the (consolidated Lithuanian) group. The new (higher) ratio then can be used to calculate new (higher) interest deductibility limitation for the specific Lithuanian company. Thus, the company may deduct exceeding borrowing costs at an amount in excess of what it would be entitled to deduct under the 30% taxable EBITDA rule.

A Lithuanian company can carry forward interest expenses that are non-deductible according to ATAD interest limitation rule for a maximum of five years and offset with future interest income.
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Real Estate
Going Global
Luxembourg

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Luxembourg

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 2018, range from 0% 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. However, the corporate income tax rules will be different depending on the tax residency of the company.

Taxation of business undertakings realised by a resident company

Corporate income tax

Corporate income tax is levied annually, based on the profit and loss account of the company, at a rate of 19.26% in fiscal year 2018 (ie, including the surcharge for the contribution to the unemployment fund). The Luxembourg tax law, however, provides that certain types of income (notably dividends, capital gains and liquidation proceeds) may be exempt from taxation under certain conditions.

Since 1 January 2016, Luxembourg levies a minimum net wealth tax (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 are subject to a minimum NWT charge of €4,815. All other corporations having their statutory seats or central administration in Luxembourg are subject to a minimum NWT charge ranging from €535 to €32,100 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.

**Municipal business tax**

The municipal business tax is a tax (collected for municipalities) which 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 corporate income tax rules. Consequently, any exemption under the corporate income tax rules should generally result in a de facto exemption under the municipal business tax rules. Moreover, a flat allowance of €17,500 is available.

**Net wealth tax**

Luxembourg companies are subject to 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 €500m;
- on a taxable base exceeding €500m: NWT of €2.5m, plus 0.05% on the component of the NWT base above €500m;
- 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.

**Withholding tax**

Under the current domestic law, there is no withholding tax levied on arm’s length interest payments, and on liquidation proceeds distributions.

The European Union (EU) Savings Directive, which exceptionally applied a withholding tax, is no longer applicable, as it has been repealed on 10 November 2015. Instead, Luxembourg have implemented the Foreign Account Tax Compliance Act (FATCA) an intergovernmental agreement between the USA and the Automatic Exchange of Information (AEOI).

On 1 July 2015, Luxembourg Parliament adopted the law implementing the FATCA. The law imposes extensive regulations and aim to detect US tax evasion. This law notably confirms the AEOI between the reporting Luxembourg financial institutions (FIs) and the US Government. FATCA requires the identification of all US clients and investors as well as gathering of relevant account/capital balances and global income and proceeds. All foreign financial institutions must adapt on boarding and monitoring procedures for identifying US customers. Foreign FIs, which do not comply with the
regulations, will face a 30% withholding tax on US-sourced income for payments made on or after 1 July 2014 regardless if they have US clients or not.

In parallel, the Luxembourg Parliament approved on 9 December 2015 the Bill No 6858 introducing the AEOI. The AEOI Law implements the EU Directive on Administrative Cooperation as regards the mandatory Automatic Exchange of Information in the field of taxation (DAC) and introduced the OECD Common Reporting Standard (CRS). The AEOI Law requires that the FIs communicate not only for FATCA purposes, but also concerning individuals and certain entities resident in EU Member States or certain third countries. The AEOI Law is applicable since 1 January 2016 in Luxembourg.

A 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, 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 withholding tax 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 a 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 (Parent-Subsidiary Directive);
  - a Luxembourg permanent establishment of a company resident in a EU Member State and falling under article 2 of the foregoing Directive;
  - a Luxembourg permanent establishment of a joint-stock company resident in a state with which Luxembourg has concluded a double tax treaty; or
  - a collective entity subject to a tax corresponding to the Luxembourg corporate income tax (ie, a tax rate of minimum 9% assessed on a similar basis as in Luxembourg) and is a resident in a state with which Luxembourg has concluded a double tax treaty.
- 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 €1.2m 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 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 withholding tax 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 withholding tax exemption should be carefully analysed on a case-by-case basis.

Transfer pricing
On 27 December 2016, the Luxembourg tax authorities issued a new transfer pricing Circular in relation to corporations that are engaged in intra-group on-lending activities financed by borrowings, on the basis of new 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 2016 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 new transfer pricing Circular is applicable since 1 January 2017.

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 permanent establishment, or (in the absence of such a permanent establishment) 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 double tax treaties 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 tax payer 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
VAT-able persons performing VAT-able 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 tax payer.

VAT adjustments over a 10-year period
VAT incurred on the purchase or development/construction of immovable property is subject to adjustments over a 10-year period, either in favour of the VAT authorities or the tax payer, 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 et des domaines. 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 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).
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 ‘DAC6’), which implements new transparency rules that should be applicable for intermediaries – such as tax advisors, accountants, banks and lawyers – who design cross-border structures for their clients. The aim of DAC6 is for intermediaries to disclose potentially aggressive tax planning arrangements.

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 1) into the Luxembourg domestic law. The ATAD should impact the interest limitation rules, the controlled foreign company (CFC) rules, the intra-EU anti-hybrid rule and the general anti-abuse rule (GAAR).

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'empreinte) 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 an 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, i.e., 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 2018 (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, property taxes, insurance premiums, and depreciation of buildings. We refer to the interest deduction limitation rules to be implemented by 31 December 2018 as described below.

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.

The income arising from the rental of housing to approved social organisations (e.g., 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 for the first year of occupation and the following five years, €1,500 for the subsequent five years and €1,000 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 spéculation’. 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 for a single person or €100,000 for married couple/partners taxable jointly. This allowance is available every 10 years. To this deduction can be added a specific allowance of €75,000 for sale of a main residence inherited from direct forbears. This specific allowance is available only once. For long-term capital gains, the personal income tax rate is 25% of the taxpayer’s overall effective tax rate (ie, maximum 11.45 % for 2018 + dependency contribution) if the sale occurs before 31 December 2018 (transitional measure applicable as from 1 July 2016) and then, 50 % of the taxpayer’s overall effective tax rate (maximum 22.89% for 2018 and additional 1.4% for Luxembourg residents for the sale occurring after the 31 December 2018.

**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, double tax treaties 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 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 corporate income tax 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 corporate income tax and municipal business tax at the aggregate rate of 26.01% (for Luxembourg City) for 2018.
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 FY2016. Tax losses incurred as from FY2017 may be carried for a maximum period of 17 years. Tax losses cannot be carried back in Luxembourg.

**Resident partnerships**

SCSa and SCSp are tax transparent entities, and thus not themselves subject to Luxembourg corporate income tax. 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 permanent establishment.

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 permanent establishment in Luxembourg.

**Investment through a permanent establishment (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 corporate income tax and municipal business tax at the aggregate rate of 26.01% (for Luxembourg City) for 2018.

**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 permanent establishment), 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 above section *Direct investment in Luxembourg property by individuals*). 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 corporate income tax (including the surcharge for the unemployment fund) at the rate of 19.26% for 2018. It should be noted that the scope of this may also be affected by any applicable double tax treaty.
**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, please see the section above on 'Indirect taxes - Value-added tax (VAT)'.

**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 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 (or equivalent in other currency) for an S.à r.l. and €30,000 (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 a withholding tax 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 (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 corporate income tax, or an EU company listed in the EU Parent-Subsidiary Directive, or a capital company fully liable to a tax corresponding to Luxembourg corporate income tax 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 for a single person or...
€100,000 for married couple/partners taxable jointly. The personal income tax rate is 50% of the marginal tax rate (maximum 21.8% for 2016).

**Non-resident individuals**

**Dividends**

Dividends paid by a Luxembourg resident company to a non-resident individual shareholder are subject to a withholding tax of 15%, with the possibility of reduced rates under double tax treaties.

For non-residents, this withholding tax is a final tax charge in Luxembourg. However, this withholding tax can potentially be credited against the income tax liability of the home country under a double tax treaty.

**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 (i.e., 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 (i.e., according to progressive income tax rates with a maximum to 43.60% for 2016);

- 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 21.8% for 2016).

Double tax treaties 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 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 VAT-able 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 corporate income tax and municipal business tax at the aggregate rate of 26.01% for 2018 (for Luxembourg City).

However, these dividends received may be exempt from corporate income tax 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 corporate income tax. Regarding this condition, the Luxembourg tax authorities have set the rule that the foreign tax must be assessed at a minimum rate of 9% on a taxable basis determined similarly to that in Luxembourg; or

- a company that is resident in a EU Member State and covered by article 2 of the Parent-Subsidiary Directive.

• The beneficiary company is:

  - a fully taxable Luxembourg joint-stock company;

  - a Luxembourg permanent establishment of a company that is resident in a EU Member State and falling under article 2 of the Parent-Subsidiary Directive; or

  - a Luxembourg permanent establishment of a joint-stock company that is resident in a state with which Luxembourg has concluded a double tax treaty.

• 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 €1.2m. 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 Luxembourg income tax law 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, 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 corporate income tax, the participation exemption remains available; since such situations are not subject to the anti-avoidance constraint.

The exemption from corporate income tax 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 corporate income tax and municipal business tax at the aggregate rate of 26.01% for 2016 (for Luxembourg City).

However, such capital gains can often be exempt from corporate income tax 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 9% on a taxable basis determined similarly to that in the Luxembourg, or a company that is resident in a EU Member State and falling under article 2 of the Parent-Subsidiary Directive.

- The beneficiary is:
  - a fully taxable Luxembourg joint-stock company;
  - a local permanent establishment of a company that is resident in a EU Member State and falling under article 2 of the Parent-Subsidiary Directive; or
  - a local permanent establishment of a joint-stock company that is resident in a state with which Luxembourg has concluded a double tax treaty.

- 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 €6m. 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 withholding taxes, 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
The EU Anti-Tax Avoidance Directive (ATAD 1) was published in July 2016. EU Member States have until 31 December 2018 to transpose ATAD 1 into their domestic laws.

On 19 June 2018, the Luxembourg Government tabled a draft Bill (n°7318) (the 'Draft Law'), previously approved by the Government council on 15 June 2018, before the Luxembourg Parliament (Chambre des Députés) that would implement ATAD 1 as Luxembourg domestic law. This Draft Law still needs to go through the Luxembourg legislative process, and may be subject to amendments before the final vote by the Luxembourg Parliament.

In some areas, ATAD 1 gives EU Member States different options and choices in transposition. The Draft Law reveals the choices made by the Luxembourg Government.

The Draft Law will come into force on 1 January 2019 with respect to the following measures:

- interest limitation rules (BEPS Action Point (AP) 4) – article 4 of ATAD 1;
- controlled foreign company rules, or CFC (BEPS AP 3) – articles 7 and 8 of ATAD 1;
- intra-EU anti-hybrid rule (BEPS AP 2) – article 9 of ATAD 1;
- general anti-abuse rule, or GAAR - article 6 of ATAD 1.

The exit tax rules (article 5 of ATAD 1) will come into force on 1 January 2020.

The Draft Law also includes two additional amendments to the domestic law, both not directly linked to the ATAD 1 text. These measures concern tax neutral exchanges, and the domestic definition of permanent establishment.

The Directive amending ATAD 1 regarding hybrid mismatches with third countries (ATAD 2) is not part of the Draft Law, but will be implemented at a later stage. These measures do not have to come into force in Luxembourg until 1 January 2020.

Interest limitation rules (article 4 of the ATAD) might particularly affect real estate structures.

The interest limitation rule 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). Although there are some notable differences.

The interest 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 (article 2(1)).

“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 (article 2(2)). The definitions of “borrowing costs” and “exceeding borrowing costs” are the same in the Draft Law. The Draft Law introduces a new article 168bis into the text of the principal tax legislation (LITL), setting out new interest deduction limitation rules in line with article 4 of ATAD 1. The Draft Law shows that Luxembourg has taken almost all of the relieving options offered by ATAD 1.

As exceptions to the interest limitation rules, a Member State may allow:

- full deduction if excess borrowing of the taxpayer’s (group) doesn’t exceed €3 million per year (article 4(3)(a));
- full deduction if the taxpayer is a standalone entity (article 4(3)(b)); and
- the exclusion of loans for EU long-term infrastructure projects (article 4(4)(b)).

The impact of these rules on investment structures should be monitored on a deal-by-deal basis.

In some areas, ATAD 1 gives EU Member States different options and choices in transposition. The Draft Law reveals the choices made by the Luxembourg Government.

For real estate structures with a platform in Luxembourg, the interest 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 limitation rule should not triggered 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 double tax treaty, interest charges related to the financing of the building should not be tax deductible in Luxembourg.

Should the property being located in Luxembourg, interest limitation rule might trigger additional tax leakage.

DAC6

DAC6 is applicable since 25 June 2018. DAC6 provides for a mandatory disclosure of certain cross-border arrangements by intermediaries or 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. DAC6 has entered into force on 25 June 2018. The first reportable transactions will be transactions where the first implementation step occurs between the date when DAC6 enters into force and 1 July 2020 (application date of DAC6). This information will be required to be filed with the tax authorities by intermediaries (or taxpayers) by 31 August 2020 (transitory period). Luxembourg (and other EU Member States) are required to transpose the provisions of DAC6 into
national law by 31 December 2019 and the first automatic exchange of information among EU Member States should be communicated by 31 October 2020.

MLI
On 3 July 2018, the Luxembourg Government also introduced a Bill of law approving the text of the Multilateral Instrument (MLI). Formal ratification of the MLI by Luxembourg is expected to occur once the Luxembourg Parliament will vote to approve the Bill. Luxembourg has opted to adopt the Principal Purpose Test limiting the scope of treaty benefit. Analysis would have to be done on an investment by investment basis where treaty benefit would be claimed once MLI will enter into force in Luxembourg.

VAT
A Luxembourg company merely holding shares in a property company should not be considered as a VAT-able 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 permanent establishment are subject to a withholding tax of 15%, but with the possibility to benefit from reduced rates or exemption, through application of either the Luxembourg participation exemption regime or double tax treaties.

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 double taxation treaty 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 (e.g., in the United Kingdom or in Germany).

Luxembourg companies are in principle subject to corporate income tax and municipal business tax on their worldwide income at the aggregate rate of 26.01% for 2016 (for Luxembourg City). However, generally, double tax treaties 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 corporate income tax 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 EUR. (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 double tax treaty).

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 EUR 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 double tax treaty 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 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 Luxembourg income tax laws, 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 owning 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 of 17 December 2010 (the ‘2010 Law’), as amended, or the law relating to Specialised Investment Funds of 13 February 2007, as amended (the ‘SIF Law’), or the law introducing the Reserved Alternative Investment Fund 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 régime. We refer to our comments below for further details on SIF and SICAR regimes.

**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**

<table>
<thead>
<tr>
<th>Legal forms available</th>
<th>no restriction on the type of investors authorised to invest in a Part II UCI</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>investment company with variable capital (SICAV);</td>
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<tr>
<td></td>
<td>investment company with fixed capital (SICAF);</td>
</tr>
<tr>
<td></td>
<td>contractual fund (FCP)</td>
</tr>
</tbody>
</table>

**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, 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 at the date of authorisation. The capital of any SICAV/SICAF must reach €1,250,000 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

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Definition of eligible real estate assets</td>
<td>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</td>
</tr>
<tr>
<td>Maximum investment in one property</td>
<td>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.</td>
</tr>
<tr>
<td>Minimum liquid assets in the fund</td>
<td>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</td>
</tr>
<tr>
<td>Minimum frequency of NAV calculation</td>
<td>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</td>
</tr>
<tr>
<td>Requirement for independent valuation of the properties</td>
<td>at least annually and each time properties are bought or sold; valuation to be performed by recognised professionals in the Real Estate sector</td>
</tr>
<tr>
<td>Borrowings</td>
<td>may not exceed on average 50% of the assets</td>
</tr>
</tbody>
</table>

Real Estate Going Global – Luxembourg
### 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 (SCA), 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 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 Luxembourg 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;  
• 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, 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 corporate income tax, municipal business tax and net wealth tax 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 Net Asset Value 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 taxes

Distributions by Luxembourg real estate investment funds, whether paid to resident or non-resident investors, are not subject to any Luxembourg withholding tax. Some payments may however be subject to withholding tax as a result of application of the EU Savings Directive (as implemented into Luxembourg domestic law).

Due to their tax-exempt status, withholding tax 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 withholding tax 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 double tax treaty. 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 VAT-able 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 corporate income tax 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 double tax treaties.

**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**

<table>
<thead>
<tr>
<th>Eligible investors</th>
<th>well-informed investors</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal forms available</td>
<td>public limited company (S.A.);</td>
</tr>
<tr>
<td></td>
<td>private limited company (S.à r.l.);</td>
</tr>
<tr>
<td></td>
<td>corporate partnership limited by shares (SCA);</td>
</tr>
<tr>
<td></td>
<td>limited partnership (SCS);</td>
</tr>
<tr>
<td></td>
<td>special limited partnership (SCSp);</td>
</tr>
<tr>
<td></td>
<td>cooperative company organised as a public limited company (SCoopSA).</td>
</tr>
</tbody>
</table>

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.

<table>
<thead>
<tr>
<th>Minimum capital requirement</th>
<th>Subscribed share capital including share premiums must reach €1m 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.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum frequency of NAV calculation</td>
<td>once a year</td>
</tr>
</tbody>
</table>

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 (S.C.S.) is deemed to be transparent for corporate income tax 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 Luxembourg Income Tax Law.

The SICAR is liable to the minimum net wealth tax.

**Withholding taxes**

Distributions by a SICAR, whether paid to resident or non-resident investors, are not subject to any Luxembourg withholding tax. Some payments may however be subject to withholding tax 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 double tax treaty purposes. Income paid by foreign entities to the SICAR should therefore benefit from reduced withholding tax rates according to the appropriate double tax treaty in place between Luxembourg and the source country. This equally applies to the 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 double tax treaty, due to the specific regime (ie, exemption of certain income) applied to a Luxembourg SICAR.

Withholding tax 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 withholding tax will generally not offset any Luxembourg tax.

Dividends paid by a Luxembourg taxable company to a SICAR benefit from the withholding tax 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 VAT-able 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

Compared to the common definition of securitisation as a financing process wherein an originator transfers one or more assets or risks to a securitisation vehicle (which, in turn, is financed by the issuance of securities backed by assets or collateral transferred and income generated by those assets in exchange for cash), the definition of ‘securitisation’ given by the Luxembourg Law of 22 March 2004 on Securitisation (the ‘Securitisation Law’) as amended and supplemented 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.

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 an S.A., an S.à r.l., an S.C.A. or a cooperative company organised as an S.A. 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 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 liquidated separately.

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. The securitisation fund may also be split into sub-funds, which may be liquidated separately.

Securitisation vehicles do not qualify as alternative investment funds (AIFs) within the meaning of the 2013 Law, as securitisation special purpose vehicles fall outside the scope of application of the law.

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 regulatory supervision. Broadly speaking, issues to professional investors 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. Nevertheless, a securitisation vehicle that makes at least four issues on an annual basis is not subject to CSSF supervision if it issues denominations exceeding €125,000. Moreover, as per CSSF Q&A 23 October 2013 and concerning the issuance of securities to the public, the CSSF has set down the following assessment criteria:

- issues to professional clients within the meaning of Annexe II to Directive 2004/39/EC (MiFID), as amended and supplemented, are not issues to the public;
- issues whose denominations equal or exceed €125,000 are assumed not to be issues to the public;
• the listing only of an issue on a regulated or alternative market does not ipso facto mean that the issue is to be considered as an issue to the public;

• issues distributed as private placements, whatever their denomination, are not considered as issues to the public. Whether the issue can be regarded as a private placement must be assessed on a case-by-case basis according to the communication means and the technique used to distribute securities. However, the subscription of securities by an institutional investor or financial intermediary for a subsequent placement of these securities with the public constitutes a public offering. Moreover, where the issue of securities by the securitisation undertaking is structured for the purposes of marketing by means of a "wrapper" aimed at the public, then this issue is deemed to be placed with 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 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').
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, i.e., certain illiquid investments in timber.

Depending on the investor’s needs, each property could be represented by a separate compartment, a solution which is not possible using another regulated 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 corporate income tax 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 withholding taxes, 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 VAT-able 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 (i.e., 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 (i.e., 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, i.e., 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 if VAT applies on the rent (i.e., 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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Real Estate
Going Global
Malaysia

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 23 July 2018.
Real Estate Tax Summary – Malaysia

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 Economic Planning Unit (EPU) will be required for the following situations:

- direct acquisitions of property valued at 20 million 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 (Ringgit, or MYR) 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; 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 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.

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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.
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 (e.g., 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.

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.

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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.
**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 land 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. Please refer to ‘Taxation of REITs’ section for more details.

**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 (e.g., 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:

- 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%
• 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 not 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 2018.

**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:

<table>
<thead>
<tr>
<th>Date of disposal</th>
<th>Companies</th>
<th>Individual (citizen &amp; permanent resident)</th>
<th>Individual (non-citizen)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Within 3 years from date of acquisition</td>
<td>30</td>
<td>30</td>
<td>30</td>
</tr>
<tr>
<td>In the 4th year</td>
<td>20</td>
<td>20</td>
<td>30</td>
</tr>
<tr>
<td>In the 5th year</td>
<td>15</td>
<td>15</td>
<td>30</td>
</tr>
<tr>
<td>In the 6th year and subsequent years</td>
<td>10</td>
<td>5</td>
<td>10</td>
</tr>
</tbody>
</table>

\(^4\) 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.
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 should apply when it is distributed to the investors.

Taxation of REITs

The Inland Revenue Board of Malaysia (MIRB) has issued Public Rulings in relation to REITs. They are:

- 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’.

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. 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 withholding tax should apply.

**Taxation of REIT unitholders**  
The taxation of unitholders will depend on whether the unitholders are Malaysian residents or non-residents.

**Tax treatment of unitholders**  
The tax treatment is 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 withholding tax mechanism at the following rates:

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5 Provided that in the case of a wholesale fund which is a money market fund, the exemption shall only apply to a wholesale fund which complies with the criteria as set out in the relevant guidelines of the SC.
### Real Estate Tax Summary

#### Malaysia

**Unitholders**

<table>
<thead>
<tr>
<th>Unitholders</th>
<th>Withholding tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals and all other non-corporate investors such as institutional investors (resident and non-resident)</td>
<td>10%</td>
</tr>
<tr>
<td>Non-resident corporate investors</td>
<td>24%</td>
</tr>
<tr>
<td>Resident corporate investors</td>
<td>0%</td>
</tr>
</tbody>
</table>

The withholding tax 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 withholding tax 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 withholding tax 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.

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6 This reduced rate of withholding tax is effective from 1 January 2009 to 31 December 2019.
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 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 audit, a penalty will be imposed. However, a concessory penalty rate may be imposed in a case where a voluntary disclosure was made.

Taxpayers have to prepare contemporaneous Transfer Pricing Documentation, (ie, either at the point of developing the inter-company transaction or prior to the submission of the company’s tax return). The Detailed Transfer Pricing Rules 2012 and Advanced Pricing Arrangement Guidelines 2012 have been issued on 20 July 2012.

The Transfer Pricing Guidelines 2012 have been updated to reinforce the existing standards based on current international taxation requirements, effective 15 July 2017.

Following Budget 2018, the provision relating to thin capitalisation for financial assistance between associated persons is no longer available. It was proposed in Budget 2018 that the thin capitalisation rules will be replaced by Earning Stripping Rules (ESR), a new method introduced by the Organisation for Economic Cooperation and Development (OECD) to control excessive deductibility of interest expense on loans between related parties. Under the ESR, the interest deduction on loans between related companies within the same group will be limited to a ratio as determined by a country’s tax authority, ranging from 10% to 30% of the company’s profit before tax. The ESR rules will take effect from 1 January 2019. No guidelines have been released in relation to the ESR rules to date.

**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.
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Real Estate
Going Global
Mexico

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 1 July 2018.
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 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), i.e., 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 (e.g., 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 (i.e., 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 the ownership 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 is 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 is regulated by law and traditions.

Restrictions
The Mexican Constitution and the Foreign Investments Law set restrictions on foreigners owning 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 this 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”, 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 1 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 México as a contract where there are three parties:

- grantor/trustor;
- trustee; and
- fiduciary.

There are many types of trusts, but focusing on building investment.

When an investor is willing to buy land where there is planning to develop apartments or offices building, under 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 that are worth considering is that 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 are 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 the Mexican Stock Exchange (BMV). 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) and the BMV. 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 US$8,876m or 562,500m MXN. Currently there are approximately 15 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 and Fibra Nova.

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. Several Fibra-E’s have recently been
incorporated in the Mexican market, such as the publicly traded ‘Fibra NAIM’, which was created for the construction project of the new Mexico City International Airport.

**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, 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).

**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.
Nevertheless, in January 2017, a tax incentive was published in the Official Gazette allowing taxpayers to apply a lump-sum deduction (immediate deduction) of fixed assets, including immovable property (74% in 2017 and 57% in 2018).

**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, and back-to-back rules.

**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 (e.g., 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**

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.

Withholding tax (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 (e.g., 10% to 15%) when interest is paid to a tax treaty country and specific requirements are met (e.g., the interest is arm’s length, the Mexican withholding agent receives a tax residency certificate from the foreign entity on an annual basis, etc).

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;
- 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.
- Interest should not be deductible when paid to controlled or controlling entities of the Mexican taxpayer whenever it falls in any of the following scenarios:
  - Foreign recipient entity is treated as fiscally transparent as per Mexican provisions (ie, if such entities are not considered taxpayers in its country of incorporation or where it its effective place of management is located). Unless the income obtained by such entity is subject to taxation at the level of its shareholders and the amount of the payment is within a fair market value.
  - Payment is disregarded in the country where the foreign recipient is located.
  - Payment is non-taxable for the foreign resident as per its applicable country’s 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.

**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.

**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.
Mexican REITs must have at least ten non-related investors. Also, an investor may not hold more than a 20% interest in the trust. The fiduciary shall distribute at least once a year, at the latest on the 15th of March, at least the 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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Real Estate
Going Global
New Zealand

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – New Zealand

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 (more than NZ$100m) or sensitive land (as defined in Schedule 1 of the Overseas Investment Act 2005) in New Zealand. In order to receive consent to acquire sensitive land under the OIA, the acquisition must benefit New Zealand or the foreign person must intend to reside in New Zealand indefinitely. There are different consent requirements for different types of land.

(For more information, refer to www.linz.govt.nz/overseas-investment)

From 1 October 2015, 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. In order to obtain a New Zealand tax number a New Zealand bank account is required.

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 2018-2019 tax year, which is the year ending on 31 March 2019, are as follows:

<table>
<thead>
<tr>
<th>Taxable Income</th>
<th>NZD</th>
<th>Tax Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt; 14,000</td>
<td></td>
<td>10.5</td>
</tr>
<tr>
<td>From 14,001 to 48,000</td>
<td></td>
<td>17.5</td>
</tr>
<tr>
<td>From 48,001 to 70,000</td>
<td></td>
<td>30.0</td>
</tr>
<tr>
<td>More than 70,000</td>
<td></td>
<td>33.0</td>
</tr>
</tbody>
</table>

If the owner of the property is a trust, then generally the tax rate is a flat 33%.

If the owner of the property is a company, the tax rate is a flat 28%.
Rental expenses

Expenses incurred in deriving rental income are generally deductible. Such expenses include interest on loans used to acquire the property (subject to the New Zealand thin capitalisation rules, the hybrid rules and transfer pricing requirements) as well as other property costs including repairs and maintenance, insurance, rates, administration costs and depreciation. Capital expenditure is not deductible but may be included in the acquisition cost of the property and depreciated (provided it is not capitalised to the building structure which has a depreciation rate of 0%).

In March 2018, the New Zealand Inland Revenue released a discussion document proposing that tax losses arising from residential properties (e.g., rental losses) should be ‘ring-fenced’. If the changes go ahead, taxpayers will only be able to 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). We note that the proposed changes are at a very early stage and Inland Revenue is currently reviewing submissions it has received from the public.

Capital gains on the sale of property

Currently, there is no general 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 only under the following conditions:

- The land was acquired with a purpose or intention of resale;
- If the taxpayer (or an associate) was in the business of dealing in land, developing or subdividing land, or erecting buildings;
- In certain circumstances, where the taxpayer, whether or not for business purposes, has developed or subdivided land or profited from the land being re-zoned;
- Residential land that is acquired between 1 October 2015 and 28 March 2018 and is sold within two years of acquisition. An exemption is available for property that is used as the main home; or
- Residential land that is acquired on or after 29 March 2018 and is sold within 5 years of acquisition. An exemption is available for property that is used as the main home.

Any such gains are included in taxable income and taxed at the taxpayer’s marginal tax rate.

In December 2017, the Government established a Tax Working Group (TWG) with the aim of reviewing New Zealand’s tax system. As part of this review, the TWG has been asked to consider whether a comprehensive capital gains tax should be introduced in New Zealand. The TWG is expected to release their findings in the last quarter of 2018.
Real Estate Investments – New Zealand

Tax depreciation

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.

While the depreciation rate for most buildings is 0%, certain components of buildings (such as fixtures and fittings that constitute plant and equipment) are eligible for higher depreciation rates. Non-structural items such as internal non-load-bearing walls and wiring are depreciable at rates relevant to their estimated useful life. The components of a building eligible for a higher depreciation rate are different depending on whether the building is residential or non-residential.

Taxpayers who acquired a commercial building before the 2010/2011 income year and did not separately identify and depreciate the fit-out of the building at the time of acquisition may be entitled to depreciate a fit-out pool of up to 15% of the building’s tax book value at 2% straight line per year until they dispose of the building. This concession is only available if taxpayers established the pool in their 2011/2012 income year.

The 20% depreciation loading concession on new plant and equipment was removed for assets purchased after 20 May 2010. A specific grand parenting rule was introduced stating that an item is eligible for depreciation loading if it was acquired, or there was a binding contract for its purchase or construction, on or before 20 May 2010.

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. Rental property is deemed to have been sold if the use of the property is changed 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.

Dividends and withholding tax

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 15% for persons resident in a country with which New Zealand has a tax treaty for the avoidance of double taxation. Treaties with certain countries (e.g. 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. Dividends that have full imputation credits attached to them are subject to special rules that reduce the withholding tax to 0%.

In 2016, a residential land withholding tax (RLWT) was introduced which applies to sales of New Zealand resident property where the sale price is paid or payable after 1 July 2016 by offshore persons where –

- the property has been sold within two years of acquisition (if purchased between 1 October 2015 and 28 March 2018 inclusive); or
- the property has been sold within five years of acquisition (if purchased on or after 29 March 2018).

**Tax losses**

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, a loss can be carried forward only if there is at least a 49% continuity in the ultimate individual shareholding at all times from the year in which the loss was incurred to the year in which it is used to offset profits. Companies in the same group, with 66% commonality of ultimate individual 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.

Losses cannot be carried back.

Please note the comments above in relation to the recent proposals to ring-fence rental losses.

**Thin capitalisation**

Inbound thin capitalisation rules apply to non-residents who invest in New Zealand. From the 2016 income year this includes:

- trusts where 50% or more of the settlements are made by non-residents or an associate of the non-resident; and

- where a New Zealand entity is controlled by non-residents who ‘act together’.

Outbound thin capitalisation rules apply to outbound investments by New Zealand residents (whether owned by residents or non-residents).

The aim of the legislation is to restrict interest deductibility on excessively geared assets. An apportionment of deductible interest is required where an entity’s debt percentage (calculated as total group debt/total group assets) exceeds both of the following:
• 60% from the 2011/2012 income year for “inbound” investments (previously 75%), or 75% for “outbound” investments; or

• 110% of the worldwide group’s debt percentage (or from income years beginning after 1 July 2018, where non-resident shareholders are considered to be acting together, 100% of the worldwide group’s debt percentage).

For the purposes of calculating the debt percentage, only interest-bearing debt and assets producing income are taken into account. Use of the debt-to-asset percentage differs from most thin capitalisation models, which monitor an entity’s debt-to-equity ratio.

Recent changes have been made to the thin capitalisation rules which apply from income years beginning on or after 1 July 2018. The key change that has been made is to the calculation of the debt percentage (now calculated as total group debt/total group assets less non-debt liabilities). However, the new rules will not apply where the taxpayer’s interest deductions are less than $1m, provided the debt is from an unrelated third party.

We note that the thin capitalisation changes also introduced special concessions for certain infrastructure projects which allow the debt percentage to exceed 60%.

**Other relevant taxes**

Owners of real property are assessed for property taxes by local authorities. The rates are usually determined based on either the improved or unimproved value of the land, as well as its town-planning zoning classification.

Generally, goods and services tax (GST) is levied at a rate of 15%. However, the supply of residential rental accommodation, or leasehold land by way of residential rental, is treated as being exempt from GST.

From 1 April 2011, most sales of land (and buildings) between GST-registered persons are zero-rated for GST purposes. There is a transitional rule for some land transactions entered into before 1 April 2011, where time of supply is on or after that date. No changes have been made to business-to-consumer transactions.

Stamp duty was abolished effective 20 May 1999 and is no longer 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 lands are rateable. The definition of land is very broad and may include the right to pass utilities over land, eg, power lines and water pipes. 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.

Parties to leases should consult transitional provisions applying for leases entered into before 8 August 2001.

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.

**Limitations on rates**

Revenue from general and certain targeted rates cannot exceed 30% of the total revenue from all rates sought by that local authority for that year.

Amounts referred to are exclusive of Goods and Services Tax (currently 15%).

**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) has the potential to be a significant issue 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 to the need to obtain specific permits or submit to certain discharge restrictions.

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 straightforward, albeit local authorities have a certain amount of power over whether or not they impose conditions.
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Real Estate
Going Global
Norway

Tax and legal aspects of real estate investments around the globe
2018
All information used in this content, unless otherwise stated, is up to date as of 9 August 2018.
Real Estate Tax Summary – Norway

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 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 in a Norwegian corporate investor is subject to the general Norwegian corporate tax rate of 23% (as of income year 2018).

As a starting point, interest on external bank debt is deductible for tax purposes in Norway, but bank debt that is backed with a parent company or a related party guarantee may be reclassified as internal debt and the interest cost deductions may thus be disallowed according to the Norwegian interest deduction limitation rules.

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 actually 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 23% tax on 3% of the dividends (effective tax rate of 0.69%).
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.
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 – Norway

General

According to the Real Estate Concession Act of 31 May 1974, 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 is 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 general corporate income tax rate for both resident and non-resident real estate investors is 23% as of 2018.

Rental income

Rental income and other kinds of earnings derived from real estate in Norway are taxable, regardless of whether the owner resides in Norway.

Deduction of costs

All costs related to operation and administration of the property, including depreciation, are deductible. This includes interest on loans obtained to acquire, maintain or improve the property.

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. As of 1 January 2005, the accounting principle was abandoned as the main rule for accountable business activity.

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 a 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 a maximum rate of 10% annually.

- (Group i) office buildings may be depreciated annually at a maximum rate of 2%.

In addition:

- (Group j, from fiscal year 2009) unmovable equipment that serves the use of the building (e.g., as elevators, cooling plant) may be depreciated annually at a 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 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. 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.

- The group contribution must be lawful, eg, be resolved in accordance with Norwegian Company law 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 and the real estate company’s income 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 (please see section 'Tax consolidation' in the case of share investment), while dividend distributions are not.

Withholding tax is 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.

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 take into consideration 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 external bank debt is deductible for tax purposes in Norway. However, bank debt that is backed with a parent company or a related party guarantee may be reclassified as internal debt and the interest cost deduction may be disallowed under the Norwegian interest deduction limitation rules (see below). The security package for bank facilities, etc, should, therefore, be structured carefully in order to mitigate risk of reclassifying external debt to internal debt.

Interest deductions on intra-group debt and debt subject to the limitation rules are limited to 25% (as of 2018) of a specifically defined profit (“taxable 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. Interest on external bank debt not covered by the limitation rules will reduce the capacity to deduct interest. 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 10 years.
Currently there is an applicability threshold of 5m NOK in net interest costs for the limitation rules to apply. The Norwegian Ministry of Finance has issued a discussion paper related to amending the Norwegian interest deduction limitation rules. The proposed new rules will include limitations also on third party interest and two alternative escape clauses based on a consolidated debt to equity ratio. The limitations on external debt is proposed to apply for Norwegian companies that form part of a group, as defined by rules for financial accounting, with a 10m NOK threshold. The new rules may come into effect as from the income year 2019.

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 Norwegian General 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 (e.g., 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 (i.e., 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, i.e., 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 actually 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 23% tax on 3% of the dividends (effective tax rate of 0.69%).

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 effected. If an extraordinary group contribution is given, this will, according to the tax authorities, be taxed as a dividend distribution.

**Loss carry forward 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 carry forward may be lost
or reduced due to debt remission or bankruptcy. Finally, carry forward of losses 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 normally 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 actually established and carries out genuine business activity in the EEA state.

Norwegian withholding taxes are only levied on dividends. Thus, payment of rent, 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 non-statutory rule

A non-statutory anti-avoidance regulation has been developed by the Norwegian Supreme Court and the tax authorities over a long period of time.

The non-statutory anti-avoidance regulation is applicable if a transaction (or series of transactions) is (i) mainly tax motivated and (ii) regarded as disloyal to the tax law.

If the non-statutory anti-avoidance regulation is applicable, the tax authorities are entitled to disregard the transaction/transactions for tax purposes.

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.

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\(^5\) 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 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, loss carry 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, a loss carry forward 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.

Please note that there currently is a proposal for a new statutory anti-avoidance rule. The Ministry of Finance is expected to issue the final proposal in 2018.

**Stamp duty on the transfer of real estate**

A 2.5% stamp duty is payable on the transfer of real property 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 introduced such tax as of 2016, 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 will either have to 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, e.g., 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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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Philippines

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 apply a reasonable debt-to-equity ratio when examining taxpayers.

At a practical level, the Board of Investments’ requirement that registered firms maintain a debt-to-equity ratio of 3:1, is a useful guide. If the debt-to-equity ratio is maintained below this ratio, the BIR is unlikely to raise an issue. Ratios above this level should be defensible, but at the cost of potentially having to manage a protracted dispute with the BIR.
Real Estate Investments – Philippines

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 of real estate property*

**Capital gains tax (CGT)**

Sale of real property shall be subject to a capital gains tax (CGT) of 6% on the gain presumed to have been realized 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.

**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 2012:

- sale of residential lot not exceeding 1,919,500 Philippine pesos (PHP); or
- sale of residential house and lot or other residential dwellings not exceeding 3,199,200 PHP; and
- VAT may be imposed on incidental sales.

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)**

A DST at the rate of 15 PHP for each 1,000 PHP (effectively 1.5%) is levied on the consideration paid for the real property, or its fair market value, whichever is higher.

**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 Filipino citizens, domestic corporations, resident foreigners, and non-resident foreigners engaged in trade or business in the Philippines is subject to a flat capital gains tax (CGT) of 15%. On the other hand, the sale of shares by both resident 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 a 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:

a) fair market values as determined by the Commissioner;

b) the fair market value as shown in the schedule of values fixed by the Provincial and City Assessors, or

c) 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.

Lease agreements on land and tenements are subject to DST at the rate of 6 PHP for the first 2,000 PHP and 2 PHP for every 1,000 PHP in excess of the first 2,000 PHP.

**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 a 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 a final dividend withholding tax of 25%, while dividends paid to a NRA engaged in trade or business in the Philippines are subject to withholding tax of 20%. A 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 less 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 on Philippine currency deposits with banks in the Philippines is subject to 20% final withholding tax (FWT), while interest earned by the same taxpayers on their foreign currency account deposits with banks is subject to 15% FWT.

The long-term bank deposit (ie, with a term of five years or more) of individual residents and non-resident aliens engaged in trade or business in the Philippines is exempt from income tax upon meeting certain conditions. Pre-termination of such deposit 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 exceeding 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 is a pending bill to amend the various provisions of the Tax Code particularly with reference to corporate taxes (ie, Package 2 of the Comprehensive Tax Reform Program). Thereafter, bills to regulate the valuation of real properties and amend financial taxes (ie, Package 3 and Package 4) are also being proposed. To become a law, the bill will have to pass three readings at the House of Representative and the Senate, before the final version is endorsed to the President for approval.


Real Estate Investment Trusts (REITs)

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. A REIT must be a public company.

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.

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.

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; and
- make an annual distribution of at least 90% of its distributable income to its shareholders.

The Securities and Exchange Commission (SEC) 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.
  - 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 specially 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

2018
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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Poland

Rental income

Net income received by corporate taxpayers is taxable in Poland at the general corporate income tax (CIT) rate of 19% (15% for so-called small taxpayers, i.e., entities which gross revenues for previous tax year did not exceed €1.2m). Generally, all expenses incurred by companies on earning or securing their taxable revenues, including interest paid, are deductible for corporate income tax purposes (except those costs specifically disallowed in the Polish CIT Law) as long as they have been properly documented. Costs of discontinued projects can also be deductible for CIT purposes.

Since 1 January 2018, a distinction between "capital gains basket" and "other operational activity basket" was introduced. Taxpayers are now obliged to recognize revenues and costs related to each "basket" separately.

Consolidation for income tax purposes is possible in Poland under specific and relatively strict conditions.

Thin capitalisation rules

Since 1 January 2018, the new thin capitalisation rules came into force. New rules are based on 30% tax EBITDA threshold (implementation of the EU Anti-Tax Avoidance Directive) and are applicable both to related and non-related party (bank) debt financing.

Under the new 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:

a) revenue from all sources, decreased by interest revenue (if any), minus

b) tax-deductible costs from all sources, decreased by tax-deductible depreciation write-offs and debt financing costs;

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 3m PLN in the tax year (ca. €700,000) – so-called safe harbour. For loans granted before 2018, the old rules apply to 31 December 2018.

As a side note, recently the Polish Ministry of Finance presented amendments to the Polish CIT Law, under which the interest deductibility threshold would be decreased to 20% tax EBITDA. Legislative works are at early stage but the 20% threshold may be introduced as of 1 January 2019 – further developments should be observed.
Depreciation

Tax-deductible depreciation of buildings is subject to maximum straight-line rates. Depending on the type of the building, these rates range from 1.5% to 10% annually.

Usually non-residential buildings are depreciated over 40 years (using 2.5% tax depreciation rate). 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 depreciated for tax purposes.

Loss carryforward

According to the Polish CIT Law, tax losses may be carried forward for five consecutive years, with no more than 50% of the amount of the loss from each year to be used in any one year.

Tax losses incurred since 1 January 2018 may be carried forward only within the same “basket” in which they were incurred.

Withholding taxes

Dividends

The general withholding tax with respect to dividend payments is 19%, regardless of whether the recipient is resident or non-resident. If the recipient is a non-Polish tax resident, an appropriate double tax treaty may reduce this rate.

With respect to dividends, the Polish CIT Law is generally in line with the Parent-Subsidiary Directive. Namely, a withholding tax exemption (the so-called ‘participation exemption’) applies to dividends being paid by a Polish taxpayer to EU/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 the exemption, as a rule, does not apply to distributions other than dividends.

Based on specific anti-abuse clause, the participation exemption on dividends and other profit distributions does not apply to income (revenue) generated through arrangements (or a series of arrangements) which are put in place for the main purpose – or one of the main purposes – of obtaining a tax exemption and which are not genuine (ie, are not conducted for valid commercial reasons).

Interest and royalties

The withholding tax rate on interest and royalties amounts to 20%, unless an appropriate double tax treaty provides for its reduction. There is no withholding tax on interest and royalties paid within Poland and they are generally treated as taxable revenue upon receipt.
Poland has implemented the Interest and Royalties Directive, under which EU Member States apply a tax exemption (under certain conditions) for interest and royalties paid to associated companies from other EU/EEA Member States (whereby EEA stands for the European Economic Area, consisting of the EU plus Iceland, Liechtenstein and Norway).

The said withholding tax 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 additional conditions are met.

The exemption stemming from the implementation of the Interest and Royalties Directive is available only if the payment recipient is its beneficial owner. The Polish CIT Law defines the beneficial owner as an entity which obtains the payment for its own benefit, not acting as an intermediary, representative, trustee or other entity obliged to transfer all or part of the payment to another entity.

**Intangible services**

Payments for services of intangible character (i.e., management, consulting services, and guarantees) to non-residents are subject to 20% withholding tax in Poland, unless an appropriate double tax treaty provides for more preferential taxation.

**Certificates of tax residence**

The application of withholding tax reliefs stipulated in the double tax treaties, as well as application of withholding tax exemptions resulting from implementation of the EU law is conditional upon possession by the Polish payer of a certificate of residence of the foreign recipient.

In case of tax certificates 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.

**Taxes on capital**

There are no separate capital taxes. However, commercial companies should remember that capital increases are subject to notary fees and Civil Law Activities Tax (CLAT) of 0.5%. Loans are generally subject to 2% CLAT, but a number of exemptions are available.

**Capital gains on sale of property**

Capital gains are taxed at the general CIT rate of 19% (15% for small taxpayers), unless otherwise determined by the provisions of an applicable double tax treaty.

Direct sale of a property should be recognised in the "other operational activity basket". Sale of shares may be subject to Polish taxation in the "capital gains basket".

Many treaties concluded by Poland have provided exemption from Polish taxation of capital gains on the sale of shares of Polish real estate holding companies. However, there is a tendency to renegotiate treaties and currently more and more of them include...
the so-called ‘real estate clause’, allowing Poland to tax capital gains on such disposal. Still, some treaties, including these with the Netherlands and Cyprus, do not contain such clause.

**Real estate transfer payments/VAT**

The sale of development land is generally subject to VAT at a 23% rate, recoverable under standard VAT rules. 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 transaction. Namely, sale of assets on piecemeal basis may be obligatorily taxed with VAT (at the relevant rate), obligatorily exempt from VAT or exempt from VAT with the option tax the supply. 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.

The standard 23% VAT rate is reduced to 8% with respect to supply of residential buildings qualifying for the social housing programme, which is not exempt from VAT based on the above outlined rules.

VAT at the rate of 23% is also generally applicable to income from the lease of buildings, except for residential buildings leasing, which is VAT-exempt under certain conditions. 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.

**Anti-abuse regulations**

A General Anti-Avoidance Rule (GAAR) was reintroduced to Polish tax law as of 15 July 2016.

In line with GAAR, legal transactions with the main purpose of obtaining a tax advantage contrary to the object and purpose of tax regulations shall not result in a tax benefit if the activities of the taxpayer were artificial. Tax consequences of such transactions should be assessed as if alternative “appropriate” transaction had taken place.

Apart from GAAR, the Polish CIT Law contains also specific anti-abuse provisions covering certain types of transactions (eg, mergers, dividend payments).
Real Estate Investments – Poland

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, legal transactions with the main purpose of obtaining a tax advantage contrary to the object and purpose of tax regulations shall not result in a tax benefit if the activities of the taxpayer were artificial. Tax consequences of such transactions should be assessed as if alternative “appropriate” transaction had taken place.

Individual tax rulings issued after the entry of GAAR into force shall not provide protection to events where there may be justified presumption that they are subject to GAAR. In this respect, the Tax Ordinance provides for a new tax clearance instrument, i.e., so called 'protective opinion' which is issued by the Minister of Finance.

The Minister of Finance may be expected to analyse the case more deeply than in case of individual tax rulings, where the tax authorities fully rely on the description of the background presented by the taxpayer.

**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 – tax-deductible costs limit**

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: (i) intangible services (including advisory, management, data processing, marketing, market research, insurance, guarantees etc.); (ii) royalties (including trademarks and know-how).

Restrictions may affect the excess over 3m PLN (ca. €700,000) plus 5% of tax EBITDA. 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).

Limitations should not apply to costs of (i) intangibles (e.g., license payments) directly related to development of goods / provision of services by a taxpayer or (ii) intangible services rendered by related party which are subject to advance pricing agreement (APA).

As a side note, recently the Polish Ministry of Finance presented amendments to the Polish CIT Law, under which the intangible services deductibility threshold would be increased to 10% tax EBITDA. Legislative works are at early stage but the 10% threshold may be introduced as of 1 January 2019 – further developments should be observed.
**Tax rulings and APAs**

The Tax Ordinance 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 designated Director of National Revenue Information authority. Generally, the individual tax ruling should be issued within three months of filing the application for the ruling. However, the tax authority is entitled to prolong this period if, in the authority's view, a taxpayer causes delay, eg, if the actual state or the taxpayer’s standpoint presented in the application is not sufficiently clear. In such a case, the taxpayer should be informed of the new deadline for issuing the ruling. If the deadline is not met – either the original mentioned in the Tax Ordinance or the prolonged one – it is assumed that the Director 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. Additionally, 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, compliance with the interpretation still should not be harmful 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 as a tax exemption will occur.

Under the GAAR regulations, if the description of the case presented by the taxpayer allows the tax authorities to have a reasonable presumption, that GAAR could apply, the tax authorities shall deny issuing an individual tax ruling. Additionally, even if the tax authorities issue such a ruling, the taxpayer is not protected.

Entities performing related party transactions may also apply to the Minister of Finance for Advanced Pricing Arrangements (APAs) available under certain conditions.

**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 National Bank of Poland interest rates and currently amounts to 8% per annum (which is 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% (i.e., to 4% a year, given the current standard rate) in the case of a voluntarily corrected tax return within 6 months. In case of the tax arrears which arose before 1 January 2016, the standard rate may – if voluntarily disclosed – be reduced by 25% (i.e., to 6%, given the current standard rate), but no time limit generally applies.

On the other hand, in certain cases of VAT/excise duty arrears stipulated in the Tax Ordinance, the standard rate is increased by 50% (i.e., to 12%). As a rule such an increase applies (i) if the tax authorities reveal (in the course of 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 receiving notice of a tax audit and the amount of understated liability/overstated refund exceeds 25% of the amount due.

Since 1 January 2017, there is also a specific VAT “sanction”, i.e., additional VAT liability applicable broadly if a taxpayer unrightfully deceased its VAT liability or increased VAT refund, amounting 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. 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%.

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. However, this general rule does not apply to acquisitions made by the investors of the EEA and Switzerland.

A permit from the Minister of Internal Affairs is subject to stamp duty of approximately €400. The procedure for a foreign-owned company to obtain such a permit is relatively straightforward, yet it may take up to 2 or 3 months and requires providing certain documents and information.

In addition, permits from the Minister of Internal Affairs 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 the investors of the EEA and Switzerland.

Such a permit is also subject to stamp duty of approximately €400.

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 new 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 0.3ha 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 (perpetual usufruct rights thereof) exceeding 0.3ha by entities other 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.

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 ten years and – in principle – would not be allowed to sell this real property/give it into use of third parties.

Moreover, the National Support Centre for Agriculture has the pre-emption rights covering:

- acquisition 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);

- acquisition of shares in a company which owns agricultural land (but in case of (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 National Support Centre for Agriculture has the right to make a statement on 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 the merger, de-merger or transformation.

The above right of the National Support Centre for Agriculture (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 2ha.

Currently, there is a draft law limiting the above-described agricultural restrictions with respect to certain residential investments located in cities.

**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 €1bn or whose aggregate turnover in Poland exceeds the equivalent of €50m 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.

**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.

**Closed-end investment fund**

In 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**

Capital gains from a direct sale of a real property / going concern are combined with other business income of the taxpayer and taxed at the general CIT rate of 19% (15% for small taxpayers). On the other hand, capital gains from a sale of shares in a Polish real estate rich entity are subject to 19% (15%) CIT in a separate “basket”, unless otherwise determined by the provisions of an applicable double tax treaty.

Many treaties concluded by Poland provided for exemption from Polish taxation of capital gains on the sale of shares of Polish real estate holding companies. Recently Poland has renegotiated various double tax treaties, introducing, among others, changes in taxation of real estate disposals through sales of shares. Generally new or
recently renegotiated double tax treaties 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 treaties do not feature real estate clause, eg, such a clause is not included in the treaties with the Netherlands and with Cyprus – developments in this respect, also under the OECD Multilateral Instrument, should be observed. Please note that Poland ratified the Multilateral Instrument and it entered into force on 1 July 2018.

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**

The sale of development land is generally subject to VAT at a 23% rate, recoverable under standard VAT rules.

Supplies of buildings and constructions or their parts (together with plots of land on which they are located) – classified as assets on piecemeal basis – are generally exempt from VAT. The exemption is not applicable for supplies: (i) effected before or in the course of so-called ‘first occupancy’, or (ii) effected less than two years after the ‘first occupancy’. The ‘first occupancy’ is understood to be the release 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 in performance of activity subject to VAT (eg, sale or lease). The taxpayer is entitled to resign from the above VAT exemption, provided that the vendor and the purchaser are registered VAT taxpayers and they submit to the relevant tax authorities a joint declaration confirming that they choose to tax the supply of the building, construction or its part with VAT.

VAT exemption also applies to supplies of buildings, constructions or their parts, effected before or in the course of the ‘first occupancy’, or within two years after the ‘first occupancy’, 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. In case the building, construction or its part qualifies for this exemption, the taxpayer is not allowed to opt for the VAT taxation of the effected supply.

Where the object of the transaction is classified as a going concern, sale of the real property would be out of scope of VAT. The currently prevailing practice is to treat the sale of building – even fully operational and generating 100% of the vendor's revenues and costs – as sale of assets on piecemeal basis (rather than a going concern). Hence, such transactions are commonly treated as VAT-able.

If the acquisition of real estate (land and/or buildings, constructions) is VAT-exempt or out of scope due to the classification of the object of the transaction as a going concern, CLAT of 2% is levied.
The standard 23% VAT rate is reduced to 8% with respect to supply of residential buildings qualifying for social housing programme, which is not exempt from VAT based on the above outlined rules.

Until mid-2016 direct sale of a commercial real property was usually treated by Polish tax authorities as a sale of assets on a piecemeal basis subject to VAT recoverable by a buyer.

However, the tax authorities changed their approach on acquisition of such real properties. to reclassify such transactions into a sale of a going concern and began to question recoverability of input VAT incurred by buyers. Currently, the going concern approach dominates (involving CLAT taxation). Nevertheless, VAT and CLAT treatment should be reviewed and analysed in detail in the light of the regulation and practice of the tax authorities in force at the time of acquisition / disposal of a property.

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.

Input-VAT on creation (ie, construction) or acquisition of fixed assets would be subject to recalculation during the consecutive five years (for fixed assets other than real estate the initial value of which exceeds approximately €3,500) and ten years (for real estate). Namely, if in a given calendar year of the appropriate period an asset would be used for the purpose of non-VAT-able activity, the respective amount of input-VAT on its creation/acquisition and offset against output-VAT, would have to be paid back to the tax office.

**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.

Since a local company holds the property, it is important for the holding company to be located in a jurisdiction with an appropriate double tax treaty. Selection of an appropriate jurisdiction is of considerable significance, in particular as far as taxation of capital gains on disposal of shares in real estate holding companies, as well as withholding tax treatment of various payments are concerned. However, substance and beneficial ownership requirements should be observed in this respect.

**Financing real estate in Poland**

**Debt**

**Thin capitalisation**

Since 1 January 2018, the new thin capitalisation rules came into force. New rules are based on 30% tax EBITDA threshold (implementation of the EU Anti-Tax Avoidance Directive) and are applicable both to related and non-related party (bank) debt financing.

Under the new 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:

a) revenue from all sources, decreased by interest revenue (if any), minus
b) tax-deductible costs from all sources, decreased by tax-deductible depreciation write-offs and debt financing costs; 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 3m PLN in the tax year (ca. €700,000) – 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). Recently, Polish tax authorities presented the non-preferential approach in individual tax rulings, nevertheless further developments should be observed.

Loans effectively disbursed before 1 January 2018 are subject to old thin capitalisation rules until 31 December 2018. As of 1 January 2019, all loans will be subject to the new rules.

**Transfer pricing considerations**
Transfer pricing rules also apply. Loans must bear market terms, including a market rate of interest. Poland, as a member of the Organization for Economic Cooperation and Development (OECD), has adopted the arm’s length standards enumerated in the OECD Transfer Pricing Guidelines.

Transfer pricing regulations apply also 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 2% of the amount of the loan. Loans made by banks and by non-Polish entrepreneurs whose mainstream business activity comprises granting loans and provision of credits, as well as VAT exempt loans (ie, loans which may be classified as provision of financing within the scope of VAT) provided by other entities are CLAT exempt.

Moreover, companies’ loans from direct shareholders are also not subject to CLAT.

Drawing a loan by a Polish resident from a foreign lender is not subject to any foreign exchange restrictions. Nevertheless, there is a formal requirement for reporting cross-border loans 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. 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 is taxable in Poland at the general CIT rate of 19% (15% for so-called small taxpayers, i.e., entities which gross revenues for previous tax year did not exceed €1.2m). The current rate has been in force since 2004.

Generally, all expenses incurred by companies on earning or securing their income, including interest paid, are deductible for CIT purposes (except those costs specifically disallowed in the Polish CIT 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

Accounting depreciation is similar to Western European standards. 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).

Tax-deductible depreciation is subject to maximum straight-line rates. For buildings, depending on type, 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). 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, depreciation period calculated this way cannot be shorter than ten years, i.e., 10% is the maximum annual tax depreciation rate.

Polish law provides for accelerated depreciation for assets used in conditions of intensive use. The definition of intensive use is use 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.

Land is not subject to tax depreciation. The acquisition costs of land may be recognised as tax-deductible at its disposal.

Loss carryforward

According to the Polish CIT Law, tax losses may be carried forward for five consecutive years, with no more than 50% of the amount of the loss from each year to be used in any one year.
Tax losses incurred since 1 January 2018 may be carried forward only within the same “basket” in which they were incurred.

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
A local annual property tax is assessable on real property (Real Estate Tax). The rate of tax is dependent on the location, type and purpose of a property, and is applied to the area (in case of land and buildings) or value (in case of constructions).

The maximum Real Estate Tax rates for property used for business purposes for the year 2018 may not exceed the following:

- 0.91 PLN per square metre of land;
- 23.10 PLN per square metre of buildings;
- 2% of the value of structures (ie, other real estate developments) established in accordance with specific regulations in this respect.

There have been discussions on introducing real estate tax based on the value of real estate; however, currently there are no specific plans in this respect.

VAT
VAT at the rate of 23% is generally applicable to income from the lease of buildings, except for lease of residential buildings, which is VAT-exempt under certain conditions. 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
Generally, dividend payments are subject to 19% tax, regardless whether the recipient is resident or non-resident. If the recipient is a non-Polish tax resident, the relevant double tax treaty may reduce this rate.

Since 1 January 2018, liquidation proceeds and remuneration for compulsory or automatic redemption of shares no longer benefit from WHT exemption available for dividends under the Polish CIT Law implementing the Parent-Subsidiary Directive.

Outbound dividends
Following provisions of the Parent-Subsidiary Directive, exemption from withholding tax applies to dividend payments made by Polish taxpayers abroad, subject to the following conditions being met jointly:
- The paying company 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 the EU, an EEA country, or Switzerland;

- The recipient holds directly at least 10% of shares in the Polish company paying a dividend for an uninterrupted period of at least two years (in case of the dividend payments made to the Swiss beneficiaries, the required direct shareholding amounts to at least 25%);

- The recipient is not exempt from tax on all its income, regardless of its source.

Moreover, in general, the dividend recipient has to have ownership title to the shares in the Polish company.

Pursuant to the Polish CIT Law, the above-mentioned exemption is also applicable, even if the uninterrupted holding period of two years lapses after the date when dividends are paid. However, if this condition is not ultimately met, the exemption becomes retroactively not applicable and the outstanding tax liability must be paid with late payment interest.

Based on the specific anti abuse clause, the participation exemption on dividends and other profit distributions does not apply to income (revenue) generated through arrangements (or a series of arrangements) which are put in place for the main purpose – or one of the main purposes – of obtaining a tax exemption and, which are not genuine (ie, are not conducted for valid commercial reasons).

**Domestic dividends (dividends paid between Polish companies)**

Similar exemption rules apply to Polish CIT taxpayers who receive dividends from domestic companies. A dividend is not included in the recipient’s income, if the recipient has continuously held a 10% minimum share in the capital of the payer of the dividend for at least two years.

**Inbound dividend**

Polish CIT taxpayers who receive dividends from European companies (ie, including entities of the EU, the EEA and Switzerland) and PEs thereof, do not include dividends into their worldwide income provided that a minimum 10% shareholding is maintained for at least two years. In all other cases, dividend receipts are taxed at the standard CIT rate of 19%. Double taxation is avoided by an application of the ordinary tax credit method.

**Interest and royalties**

The withholding tax rate on interest and royalties amounts to 20%, unless an appropriate double tax treaty provides for its reduction. There is no withholding tax on interest and royalties paid within Poland and they are generally treated as taxable income upon receipt.

Nevertheless, Poland implemented Interest and Royalties Directive, under which EU Member States are to apply a tax exemption (under certain conditions) for interest and royalties paid to associated companies from other EU/EEA Member States.

The said exemption may be applied, provided that the following conditions are jointly met:
• The paying company 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 country (other than Poland);

• The recipient has a direct minimum holding of 25% in the capital of the paying company, or the paying company 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 paying company;

• The recipient is not exempt from tax on all its income, regardless of its source.

The holding has to result from ownership title to the shares.

Pursuant to the Polish CIT Law, the above-mentioned exemption is also applicable in case the uninterrupted holding period of two years lapses after the date when interest or royalties are paid. However, if this condition is not ultimately met, the exemption becomes retroactively not applicable and the outstanding tax liability must be paid with late payment interest.

The exemption stemming from the implementation of the Interest and Royalties Directive is available only if the payment recipient is its beneficial owner. The Polish CIT Law defines the beneficial owner as an entity which obtains the payment for its own benefit, not acting as an intermediary, representative, trustee or other entity obliged to transfer all or part of the payment to another entity.

**Intangible services**

Payments for services of intangible character (ie, management, consulting services and guarantees) to non-residents are subject to 20% withholding tax in Poland, unless appropriate double tax treaty provides otherwise.

**Withholding tax - other requirements for applying exemptions/reduced rates**

Application of withholding tax exemptions for dividends/interest/royalties (based on the Polish tax regulations implementing provisions of the EU directives) is conditional upon existence of provisions (in the relevant double tax treaty) allowing for exchange of tax information between the tax authorities of Poland and the country of the payment recipient.

Application of the withholding tax reliefs based on provisions of the double tax treaties as well as on the EU directives (with respect to dividends/interest/royalties/intangible services) would be conditional upon possession by the paying company of a relevant certificate of tax residence of the recipient.

In case of tax certificates which do not specify the period for which they are issued, such certificates should be treated as valid for 12 months from the date of issue. Thus, an annual review of collected tax certificates is generally required.
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Real Estate
Going Global
Portugal

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 24 July 2018.
Understanding the basic principles

Legal environment
Definition of real estate activities
For legal purposes, the definition of real estate promoter is included in Law No 68/04 of 25 March, and is defined as any person, individual or legal, private or public, who directly or indirectly decides, promotes, schedules and finances with its own or other resources, the building constructions or reconstructions destined for housing to be enjoyed by itself, or to be sold or leased.

The definition of real estate lessor is the person, individual or entity that leases urban real estate.

Investors acquiring property via a corporate structure are subject to a beneficial owner register, in compliance with Law no 83/2017, of 8 August, setting out anti-money laundering and anti-terrorism financing measures.

In addition, and again aiming at complying with the abovementioned legislation, the ultimate beneficial owner(s) of the corporate structure may be: (i) physical person(s) who is/are directly or indirectly owner(s) of stockholdings representing more than 25% of the company share capital; (ii) physical person(s) that by means of an agreement, including without limitation a shareholders’ agreement, hold(s) more than half of the voting rights at the general meeting of the company or the right to appoint more than half of the company’s board of directors; or (iii) if none of the two foregoing circumstances are applicable, the director(s) of the company.

Please note that Lawyers and Notary Publics are bound to a communication obligation to the relevant bar association when they suspect of an illegal source of financing when handling a client’s legal situation. Also, and to the extent of preventing money-laundering activities, payments above €3,000 cannot be made in cash.

The property right
The property right is set forth in the Constitution of the Portuguese Republic and generally no one can be deprived of their property, except in cases of public utility and always subject to a compensation.

This is an exclusive and complete right to possess, enjoy and dispose of an interest in property. In order to create a more than merely contractual right and to ensure interest in real estate vis-à-vis third parties, real estate must be registered before the Land Registry Office.

The surface right (direito de superfície)
A surface right is defined in the civil code as the right to build and maintain a building, or use and enjoy a building situated on or over land which is owned by a third party. The right can be established for a limited period of time or be granted in perpetuity. In
order to have effect vis-à-vis third parties, registration in the Land Registry Office is required.

Construction right
According to the “Lei de Bases Gerais da Política Pública dos Solos, de Ordenamento do Território e de Urbanismo”, Law no 31/2014 of 30 May, the owner of a plot has the right to construct. However, the owner must obtain specific licenses, 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
Usufruct is contemplated in the Portuguese civil code and consists of a right to use and enjoy a third party’s property for a certain period of time, for the life of the beneficiary. In the event that the beneficiary is a legal person it is limited to a period of 30 years. In order to have effect vis-à-vis third parties, registration in the Land Registry Office is required.

Regarding other figures of divided property (“Direitos reais de gozo”), the regime of community of owners of a building which is legally and physically divided into several units (condominium) is worthy of mention.

The incorporation of a property into this regime must be made by means of a public deed or an authenticated document and typically will occur at the same time the condominium regulations. The incorporation title of the condominium (“Título constitutivo da propriedade horizontal”) contain the terms and conditions for the use of the common areas and sets out the rules for the management of the property.

Additionally, it contains a formula to determine the amount attributable to each unit for maintenance of the common parts of the property, services and common costs. The incorporation title of the condominium must be duly registered in the Land Registry Office.

Another form of divided property is the joint-ownership over the same property between two or more owners. A co-owner may have a bigger quota over the property, nonetheless his rights and obligations remain equal when compared to a co-owner with a lower quota. Co-owners may divide the property and that division can be executed by agreement or according to procedure law.

Finally, time-sharing (“Direito real de habitação periódica”) should be mentioned. This right refers to property related to tourism and the hospitality industry and it is granted temporally (usually one week per year).

Restrictions on ownership by foreigners
There are no restrictions on Foreigners owning property in Portugal. Actually, Portugal has been undertaking a series of measures to attract new and foreign investment to the country. Namely, through the establishment of a residency permit program (commonly referred to as “Golden Visas”) and a more favourable tax regime, when compared to other EU Member States.

Lease agreements
Lease agreements are specifically included in the civil code, which distinguishes between urban leases and rural leases. 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 length is 30 years.

Also, and unless parties agree otherwise, in order to sublease property the landlord’s prior written consent is mandatory, otherwise the landlord may terminate the contract based on tenant’s default.

**Administrative concessions**

This type of contract is regulated in the Public Contracts Law and is divided into concession of public services or public works.

Concession of Public Services is defined as a contract in which the concessioner has the obligation to manage at his own risk a certain public service activity, and obtain the profits that result from the activity.

Concession of Public Works can be defined as the contract in which the concessioner has the obligation to execute a public work and the respective right to exploit, for a certain period of time.

**Town planning regulations**

Zoning and planning is mainly governed by a planning policy foreseen by Decree Law no. 80/2015, of 14 May 2015.

All plans bind public entities and private individuals are subject to special and municipal plans.

The relevant urban plan sets forth whether the real estate owner may construct a new building or restore the existing one. The construction rules are set out by building regulations including the General Regulations of Urban Buildings (*Regulamento Geral das Edificações Urbanas*, from 1951).

Municipal plans establish the allowed use according to the sector (housing, commerce and services, industry, agriculture, etc.).

The main relevant authorities in what regards town planning regulations are the municipalities. These local public bodies 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 in order to obtain an official statement on the feasibility of the project.

Finally, the use of properties is, by principle, subject to a Municipal Use Permit.

**Tax environment**

**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, i.e., permanent establishments (PEs) of non-resident companies, when obtaining net rental income, they 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 carry forward.

State surtax (derrama estadual) also accrues as follows: (i) 3% for taxable profit between €1.5m and €7.5m; (ii) 5% for taxable profit above €7.5m and up to €35m; and (iii) 9% for taxable profit above €35m.

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 a 2% annual rate for flats or apartments, offices and commercial property and at a 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 (i.e., 100 years), at a 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 a 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 carry forward**

The carry forward period for tax losses generated in 2013 was 5 years. From 2014 to 2016, tax losses can be carried forward for 12 years. For tax losses generated in 2017 onwards the carry forward period will be 5 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 5 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.
Real Estate Investments – Portugal

Direct investments in Portuguese property

Corporate and individual investors planning to invest in property located in Portugal may choose from various different methods to structure such an investment. Basically, they can opt between a direct or indirect acquisition, ie, through the purchase of shares in a company owning property in Portugal purchase of units in Collective Investment Vehicles. The main tax issues arising from direct investments are addressed in this section.

General
Companies and individuals wishing to invest in Portuguese property may opt for a direct purchase of the property.

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 VAT status should be checked. If necessary, the seller should be asked for certain guarantees on possible tax liabilities.

Legal aspects
Promissory sale and purchase agreement, purchase option, unilateral promise to sell/buy
Promissory sale and purchase agreement, and purchase options or the unilateral promises to sell/buy, can be executed before a notary public or, alternatively, privately between parties. It can be recorded at the Land Registry Office.

Purchase option
Under a purchase option agreement, the seller, referred to as a 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 said property.

The fact of the beneficiary signing the promise and consequently accepting it, does not bind him to buy the property. If the beneficiary exercises the option to buy up until the agreed term, the sale is completed. If not, then the seller is free to sell the property to a third party.

In order to enforce this Purchase option vis-à-vis third parties the purchase option must be registered before the Land Registry Office.

Promise to sell/buy
This type of agreement entails an obligation to sell and an obligation to buy implying a reciprocal undertaking, consequently it is possible to claim the performance (execução específica) of the abovementioned agreement before a court.
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 a 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 carry forward.

State surtax (derrama estadual) also accrues as follows: (i) 3% for taxable profit between €1.5m and €7.5m; (ii) 5% for taxable profit above €7.5m and up to €35m; and (iii) 9% for taxable profit above €35m.

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 (e.g., 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 (i.e., 100 years), at a 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, e.g., 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 5 years. From 2014 to 2016 the carry forward changed to 12 years. For tax losses generated in 2017 the carry forward period will be 5 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.

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 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 a 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 a 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 and €250,000 and of 5% on taxable income exceeding €250,000 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 and €250,000 and of 5% on taxable income exceeding €250,000 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, i.e., 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 and €250,000 and of 5% on taxable income exceeding €250,000 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 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; (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 2018 less than €92,407).

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 31 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.
• 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.

• 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 1 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 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 €1.2m.

In case of individuals, the following rates apply:

• 0.7% for properties with a taxable basis (after the deduction of the referred deductions) not exceeding €1m (or €2m 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 exceeds €1m.

In case of properties owned by corporations it is applicable a rate of 0.4% on the taxable basis. 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 is 0.7% for the taxable basis up to €1m and 1% for the part of the taxable basis that exceeds such amount.

Properties owned by entities domiciled in a tax haven, the Additional to the IMI is levied at a 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 there are two types of construction contracts: (i) if the construction owner is a public entity, the contract is regulated by the Portuguese Law of Public Contracts; or (ii) if the construction owner is not a public entity, the construction contract regulated by the Portuguese Civil Code.

In Portugal, pursuant to article 89 of the Decree Law 555/99, of 16 December (“Regime Jurídico da Urbanização e Edificação”) there is a duty of conservation imposed on building owners. Law imposes an obligation of performing conservation works at least, every eight years. If a building is in danger of collapsing, the municipality may order its demolition.

Also, according to Decree Law, 307/2009 of 23 October, there are some situations where urban rehabilitation may be performed under this specific framework, 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 five 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.

- Income obtained by both individuals and corporate investors and derived from the units held in the referred funds is subject to a 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; (ii) 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, i.e., 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, 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 (10 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 (10)-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 property 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
Corporations in Portugal
The most common vehicles for investment are the private limited liability company, *(Sociedade por Quotas, or SQ)*, and joint-stock company *(Sociedade Anónima, or S.A.)*.

Joint-stock company *(Sociedade Anónima)*
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.

Private limited liability company
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, save for transfers to other shareholders or family (spouse, ascendants, descendants) and unless the consent requirement is waived by the by-laws of the company or by means of a quotaholder’s agreement.

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 double tax treaties 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 double tax treaty 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 and €250,000 and of 5% on taxable income exceeding €250,000 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 double tax treaties 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 double tax treaty 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 an 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).

**General**

**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 and it is ruled in the fund by laws.
It is mandatory that they are managed by management companies, which must be incorporated as joint-stock companies (Sociedades Anónimas, or 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 to be considered
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/farm land; (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 double tax treaty 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 2013, 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.
• 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 (Sociedade Anónima), 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.
Financing the acquisition of Portuguese property

Legal aspects

Minimum share capital
One of the main differences between a private limited liability company (Sociedade por quotas) and a joint-stock company (Sociedade Anónima) is the minimum share capital required for their incorporation.

For a Sociedade Anónima the requirement is €50,000 and the payment of 70% of the contributions to be made in cash may be deferred. For a Sociedade por Quotas the requirement is €1 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 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 relevant 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 mean 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: €1m; or a (ii) variable cap: 30% of the profit obtained before depreciation, net financing expenses and taxes (for simplification purposes also referred to as tax EBITDA).

**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 a 25% (or 35% if due to a resident in a country, territory or region subject to a clearly more favourable tax regime) flat withholding rate, in cases where the entity receiving the interest is resident in a country that has not signed a double tax treaty 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 a final withholding tax rate of 35%, unless the beneficial owner of the income is identified.

Where the beneficiary is resident in a country that has concluded a double tax treaty with Portugal, the withholding 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**

The financial lease contract (*Contrato de Locação Financeira*) is regulated in Decree-Law No. 149/95 of 24 June, and is defined as the contract where one party (finance lessor) grants a finance loan and also, upon monthly instalments, a temporary use of property, under an agreed term. The other party (finance lessee) undertakes to pay the monthly instalments and to render the property by the end of the agreed period, unless it opts to buy the property.

A financial lease agreement can be performed in a private document, but signatures must be certified. Also, the construction/use permit must be certified alongside with the signatures.

Once the financial lease agreement term elapses, the lessee has three options: (i) exercise the purchase option for a certain amount; (ii) return the property to the leaser; and (iii) renew the contract 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
2018
Real Estate Tax Summary – Romania

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 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 (at least 12 minimum gross salaries per year, currently equal to 22,800 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 a flat rate of 10%. From 1 January 2018, rental income is also subject to individual health contribution of 10% if it exceeds a certain threshold (at least 12 minimum gross salaries per year, currently equal to 22,800 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 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 – Romania**

**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:

- 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; and
- the pre-emption right of the co-owners, lessees, neighbours or of the state for agricultural land located outside the buildable area of the municipality.

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.

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 (i.e., 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 shall register the operation with the Land Register.

**Time-sharing legislation**


**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 (e.g., 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

Introduction

Set out below are the main provisions within the Fiscal Code regarding real estate. 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.

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. €100,000). 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 day 25 of the month following the one when 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 they exceed a certain threshold (12 minimum gross salaries per year, which amount currently to RON 22,800 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 permanent establishment (PE) in Romania.

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 continue to 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 annual 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 a flat rate of 10%. As from 1 January 2018, rental income is also subject to individual health contribution of 10% if it exceeds a certain threshold (12 minimum gross salaries per year, which currently amount to 22,800 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.
Foreign individuals who earn rental income are required to submit a statement on the income estimate within 15 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 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; 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 carry forward**
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**
As from 1 January 2018, there is no distinction anymore between the tax regime of
intra-group or bank financing, irrespective of the company capitalization or its debt to
equity ratio, since the tax deduction rule has been normalized 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
€200,000 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.

Equally important is that the above cap affects also 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.

There have been constant debates on increasing the deduction thresholds to level
partially or fully the European thresholds, which are set at €3 million and 30% of
EBITDA. This is something to watch closely in 2019, as well.
**Turnover tax**

All newly set up companies and companies in Romania with a turnover less than €1m as at 31 December 2017 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.

This rule was changed on 1 April 2018 to allow companies to opt out of the turnover tax regime, 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 general 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 includes also dwellings and parts thereof supplied as housing with a maximum useful surface of 120 square meters, 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, exclusive of VAT. The reduced VAT rate is also applicable to the supply of the land beneath the house on the condition that it does not exceed 250 square meters, including the footprint of the house. Any unmarried person can purchase a dwelling under the social policy, if she/he did not acquire in the past another dwelling with 5% VAT. In addition, any family can purchase a house under the social policy, if the husband or the wife, separately or together, did not acquire a building in the past with 5% VAT.

- **Taxation under the reverse charge mechanism** – for supplies of plots of building land or new buildings, provided that 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.

**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.

These provisions also apply for real estate assets that were in the adjustment period starting from 1 January 2017 for those events that generate VAT adjustments incurred after 1 January 2017.

**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.

**VAT split payment system**

Starting with 1 January 2018, VAT split payment system is mandatory in Romania for all private and public companies registered for VAT purposes, provided that such companies are under insolvency procedures or they have incurred VAT debts exceeding certain thresholds. Taxpayers can also opt to apply the VAT split payment mechanism, by way of submitting to the tax authorities a notification in this respect. The taxpayers opting to apply the system will benefit of a grant of 5% tax on profit or, as the case may be, the revenue tax on microenterprises.

Taxpayers applying the VAT split system have the obligation to open a VAT account at state treasury units or credit institutions that will be used for cashing / paying the VAT related to taxable supplies of goods / services and inform their clients about the dedicated VAT account. The account should have a special IBAN that will include the character string "VAT".

Taxable persons registered in VAT purposes in Romania (ie, companies, individuals, public institutions and non-resident companies registered directly or through fiscal representatives) not applying the VAT split payment system have the obligation to pay the VAT related to taxable supplies of goods/services in the dedicated VAT account of their suppliers applying this system.

**Import of equipment**

VAT on imported goods is paid in customs, except for imports made by taxable persons registered for VAT purposes that obtain an import VAT deferment certificate from the customs authorities. In the latter situation, the VAT is not paid in customs, but shown 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 be also obtained by companies with the status of Approved Economic Operators (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.

**Domestic withholding taxes (WHT)**

A 16% withholding tax 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 years 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 withholding tax.

The EU Interest and Royalties Directive is also applicable so that no withholding tax may be levied for interest and royalty payments made between related parties, provided the conditions of minimum 25% direct association and a two-year holding period are met.
The aforementioned domestic withholding tax 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; so, based on its provisions, the notary public fee for authenticating the sale and purchase agreement of a real estate is computed as follows:

<table>
<thead>
<tr>
<th>Value of the transaction</th>
<th>Amount of the fees</th>
</tr>
</thead>
<tbody>
<tr>
<td>Below 15,000</td>
<td>2.2% but no less than 150</td>
</tr>
<tr>
<td>From 15,001 to 30,000</td>
<td>330 + 1.6% for the amount exceeding 15,001</td>
</tr>
<tr>
<td>From 30,001 to 60,000</td>
<td>580 + 1.3% for the amount exceeding 30,001</td>
</tr>
<tr>
<td>From 60,001 to 300,000</td>
<td>970 + 0.9% for the amount exceeding 60,001</td>
</tr>
<tr>
<td>From 300,001 to 600,000</td>
<td>3,130 + 0.65% for the amount exceeding 300,001</td>
</tr>
<tr>
<td>More than 600,001</td>
<td>5,080 + 0.44% for the amount exceeding 600,001</td>
</tr>
</tbody>
</table>

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 2 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 5 years preceding the reference year; the value of the construction works, in the case of new buildings constructed in the past 5 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 a 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
Singapore

Tax and legal aspects of real estate investments around the globe

2018
All information used in this content, unless otherwise stated, is up to date as of 29 August 2018.
Real Estate Tax Summary – Singapore

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 losses and excess tax depreciation (see section 'Tax depreciation and losses' below).

Withholding tax of 15% applies to interest paid to a foreign lender. 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 the restrictions outlined above.

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 the 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 straight-line over three years. 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 30 June 2020. 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 SGD over a three year period.

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. 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:

<table>
<thead>
<tr>
<th>Purchase price or market value</th>
<th>Stamp duty rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>SGD</td>
<td>%</td>
</tr>
<tr>
<td>For the first 180,000</td>
<td>1</td>
</tr>
<tr>
<td>For the next 180,000</td>
<td>2</td>
</tr>
<tr>
<td>For amounts in excess of 360,000</td>
<td>3</td>
</tr>
</tbody>
</table>
For residential property, the stamp duty rates are as follows:

<table>
<thead>
<tr>
<th>Purchase price or market value</th>
<th>Stamp duty rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>SGD</td>
<td>%</td>
</tr>
<tr>
<td>For the first 180,000</td>
<td>1</td>
</tr>
<tr>
<td>For the next 180,000</td>
<td>2</td>
</tr>
<tr>
<td>For the next 640,000</td>
<td>3</td>
</tr>
<tr>
<td>For amounts in excess of 1,000,000</td>
<td>4</td>
</tr>
</tbody>
</table>

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):

<table>
<thead>
<tr>
<th>Profile of buyer</th>
<th>ABSD rates from 8 December 2011 to 11 January 2013</th>
<th>ABSD rates from 12 January 2013 to 5 July 2018</th>
<th>ABSD rates on/after 6 July 2018</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore citizens (SC) buying first residential property</td>
<td>n/a</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td>SC buying second residential property</td>
<td>n/a</td>
<td>7</td>
<td>12</td>
</tr>
<tr>
<td>SC buying third and subsequent residential property</td>
<td>3</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Singapore permanent resident (SPR) buying first residential property</td>
<td>n/a</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>SPR buying second and subsequent residential property</td>
<td>3</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>Foreigners (FR) buying any residential property</td>
<td>10</td>
<td>15</td>
<td>20</td>
</tr>
</tbody>
</table>
A seller’s stamp duty (SSD) is imposed on residential properties purchased on or after 20 February 2010 and sold within 4 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:

<table>
<thead>
<tr>
<th>Holding period</th>
<th>Residential property SSD rate</th>
<th>Industrial property SSD rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 year</td>
<td>12%</td>
<td>15%</td>
</tr>
<tr>
<td>More than 1 year and up to 2 years</td>
<td>8%</td>
<td>10%</td>
</tr>
<tr>
<td>More than 2 years and up to 3 years</td>
<td>4%</td>
<td>5%</td>
</tr>
<tr>
<td>More than 3 years</td>
<td>no SSD payable</td>
<td>no SSD payable</td>
</tr>
</tbody>
</table>

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 of the PHE or who become one after the purchase.

With effect from 6 July 2018, 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.

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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.
5 Applicable SSD rates for industrial properties acquired on or after 12 January 2013.
For sellers, 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)**

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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6 Properties under the exclusion list:
- accommodation facilities within any sports and recreational club;
- chalet;
- child care centre, student care centre, or kindergarten;
- welfare home;
- hospital, hospice, or place for rehabilitation, convalescence, nursing care or similar purposes;
- hotel, backpackers' hostel, boarding house or guest house;
- serviced apartment;
- staff quarters that are part of any property exempted from tax under s6(6) of the Property Tax Act;
- student's boarding house or hostel;
- workers' dormitory.

For the prevailing property tax rate of 10% to apply, the property must have received planning approval for the above use.
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Real Estate
Going Global
Slovakia

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 13 July 2018.
Real Estate Tax Summary – Slovakia

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
- Limited liability company (s.r.o.)
- Limited partnership
- General partnership

Rental income

Rental income is part of the corporate income tax base and is taxed as ordinary income. It is subject to the standard corporate tax rate of 21%. 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 19%/25% tax rate. The tax base of up to 176.8 times the subsistence level (ie, €35,268.06) is subject to a 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 six tax depreciation groups for assets with depreciation periods ranging from 4 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 on leased fixed asset (including real estate) cannot exceed the annual rental income 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.
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 – Slovakia

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, i.e., 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. The co-owner has the exclusive use of the share for the purpose for which it is intended and a share of the common parts of the property and share of the land.

In case that the construction and technical designation of the building allows, residential and non-residential premises 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 real estate co-ownership.

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. 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, assessing 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 agreement 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 is written and must 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 assesses, whether it is compliant with the Cadastral Operate (ie, other real estate and its cadastral documentation in the surrounding area).

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.

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 carried 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 with the few exceptions set out by the law.
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 when the application is submitted electronically (using a qualified electronic signature), or €66 when the application is submitted in a paper form.

The application for expeditious proceeding is charged by a fee of €266.

**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).

From 1 January 2018, interest expenses under an intercompany loan (as well as any other expenses incurred in respect of a related party) would not be tax deductible in portion corresponding to the amount:

1) when double deduction is achieved;

2) of a non-taxable income (income not subject to tax);

3) of funds if the funds are used (directly/indirectly) by a related party to repay (fully/partially) the expenses as stated above under points 1) or 2).

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. In particular,

- if property is treated as non-business asset, only monthly utility expenses can be deducted (eg, gas, electricity).
- if property is treated as business asset, various related expenses incurred in maintaining and securing rental income can be deducted (eg, Slovak tax depreciation, utilities, maintenance fees, repairs, mortgage interest). At the same time, tax evidence will be required to be maintained under this option.

Also, the first €500 (for 2018) 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 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 flat rate of 21%. Losses realised on the sale of buildings, but not land and 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 (e.g., employment income, rental income, sale of property) of up to 176.8 times the applicable subsistence level (i.e., € 35,268.06 in 2018) is subject to a 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 (in cases where the criterion was already met before 1 January 2018, the 24 month period would be calculated from 1 January 2018); 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 analyses is required to choose the best option.

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, but the charging of an exempt rental fee limits the landlord’s ability to deduct related input VAT. As a result, in certain circumstances, the lessor can opt to charge 20% VAT on the lease.

The supply of real estate is VAT-exempt, except for supplies made within five years after the first approval of the building or within five years from the day when the building was ready to use for the first time. However, the seller can decide that such supply of real estate will not be exempt from VAT. 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 obligation to notify the customer in writing of its decision on taxation by the deadline for issuing an invoice. In addition, if such transaction is carried out between two Slovak VAT payers, the VAT liability would be shifted to the customer under the reverse charge mechanism.

We would like to point out that the above rules will likely change from 2019. According to the available draft of amendment of Slovak VAT Act that should be effective after final approval as of 1 January 2019, there will be rather substantial changes in respect of supply and renting of real estates. According to the draft amendment, a taxpayer selling real estate for housing purposes after five years from the first approval of real estate or from the day when real estate was put in use or and a taxpayer renting real estate for housing purposes will not be able to decide to tax the supply but will have to apply VAT exemption.

The period for adjustment of the input VAT deduction on a real estate (immovable property) in case of change of its intended use is twenty years. As of 1 January 2018, a mandatory twenty-year obligation for adjustment of VAT deducted applies to all types of constructions. The period for archiving invoices received in relation to such immovable property is twenty years.

In the light of the above mentioned proposed changes, a taxpayer who deducted VAT at the time of purchase of real estate for housing, will be automatically obliged to make an adjustment of deducted input VAT when selling such real estate after a five-year period and before the end of the twenty-year adjustments period. The same obligation will apply also in case of renting real estate for housing purposes.

Supply of real estate or part of real estate in Slovakia, 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 is reached by such a sale and the seller opted to tax it.

As of 1 January 2016, 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 rent 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-contracting states” (i.e. states that did not either conclude a double tax treaty or tax information exchange agreement with the Slovak Republic or where a Slovak tax payer is not able to prove the beneficial ownership status of income recipient).

No tax securement is required for rental payments/income from transfer of shares paid to EU/EEA-resident entities, assuming such non-resident is beneficial owner of received income.

The tax securement is considered a tax advance. The entity/individual receiving the rental income should file a Slovak tax return, and calculate its Slovak tax base (i.e., 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 to be a final tax.

The gain from disposal of shares in a Slovak company is generally subject to 21% corporate income tax. In practice, some double tax treaties may provide protection from Slovak taxation of non-resident capital gain from disposal of shares in Slovak companies.

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-contracting state”);
- 0% WHT, if paid to a company or a tax resident of a “contracting state” (there is a double tax treaty (DTT) or tax information exchange agreement in place), provided such company is the beneficial owner of income; and
- 35% WHT, if paid to a company or tax resident of a “non-contracting state”, 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-contracting 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 withholding tax of 10%/35% (in case of taxpayers from non-contracting 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 permanent establishment (PE) to which the gain can be attributed.

**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 a tax loss equally over a period of four years following the year in which the loss arose.

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.

**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.
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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018
Real Estate Tax Summary – South Africa

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 2018/19 tax year ending on 28 February 2019, the highest rate of 45% applies to taxable income in excess of 1.5m 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.
The Department may permit SA companies which are wholly owned subsidiaries of non-residents to borrow locally up to 100% of the total shareholder’s investment; this is generally known as the company’s ‘borrowing base’ or ‘effective capital’. In order to further liberalise the above-mentioned restriction, the regulations allow for an increase in effective capital proportionate to increases in local participation in the shareholding of the entity.

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:

<table>
<thead>
<tr>
<th>Date when the building was erected</th>
<th>Annual write-off rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 01/01/1989</td>
<td>2</td>
</tr>
<tr>
<td>On or after 01/01/1989</td>
<td>5</td>
</tr>
</tbody>
</table>

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:

<table>
<thead>
<tr>
<th>Date when the building was erected</th>
<th>Annual write-off rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Before 4 June 1988</td>
<td>2</td>
</tr>
<tr>
<td>From 4 June 1988 onwards</td>
<td>5</td>
</tr>
<tr>
<td>From 17 March 1993, in respect of improvements that do not extend the exterior structure of the building</td>
<td>20</td>
</tr>
</tbody>
</table>

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 will come into operation on the date that the Special Economic Zones Act No. 16 of 2014 comes into operation.

**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:

- immovable 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 immovable 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 immovable property situated in SA. This excludes immovable 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 immovable 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 (i.e., 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:

<table>
<thead>
<tr>
<th>Type of taxpayer</th>
<th>Inclusion rate %</th>
<th>Statutory rate %</th>
<th>Effective rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals</td>
<td>33.3</td>
<td>0–40</td>
<td>0–13.3</td>
</tr>
<tr>
<td>Individuals</td>
<td>33.3</td>
<td>0-41</td>
<td>0-13.7</td>
</tr>
<tr>
<td>(01/03/2015 until 29/02/2016)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Trusts</td>
<td>66.6</td>
<td>40</td>
<td>26.7</td>
</tr>
<tr>
<td>Companies</td>
<td>66.6</td>
<td>28</td>
<td>18.6</td>
</tr>
<tr>
<td>PEs (branches)</td>
<td>66.6</td>
<td>28</td>
<td>18.6</td>
</tr>
</tbody>
</table>

For years of assessment commencing on or after 1 March 2016 the effective CGT rates are as follows:

<table>
<thead>
<tr>
<th>Type of taxpayer</th>
<th>Inclusion rate %</th>
<th>Statutory rate %</th>
<th>Effective rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individuals/Special Trusts</td>
<td>40</td>
<td>0-41</td>
<td>0-18</td>
</tr>
<tr>
<td>Other Trusts</td>
<td>80</td>
<td>41</td>
<td>32.8</td>
</tr>
<tr>
<td>Companies</td>
<td>80</td>
<td>28</td>
<td>22.4</td>
</tr>
<tr>
<td>PEs (branches)</td>
<td>80</td>
<td>28</td>
<td>22.4</td>
</tr>
</tbody>
</table>

Gains realised on the sale of property are generally subject to CGT. Certain exemptions, however, exist in this regard, e.g., an exemption of the gains from the sale of the property used as a primary residence to the limit of 2m 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 2m 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 carry-forward

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 residential accommodation, 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 income from other sources. 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:

<table>
<thead>
<tr>
<th>Value of property (ZAR)</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 - 900,000</td>
<td>0%</td>
</tr>
<tr>
<td>900,001 – 1,250,000</td>
<td>3% on the value above 900,000 ZAR</td>
</tr>
<tr>
<td>1,250,001 – 1,750,000</td>
<td>10,500 ZAR + 6% on the value &gt; 1,250,000 ZAR</td>
</tr>
<tr>
<td>1,750,001 – 2,250,000</td>
<td>40,500 ZAR + 8% on the value &gt; 1,750,000 ZAR</td>
</tr>
<tr>
<td>2,250,001 – 10m</td>
<td>80,500 ZAR + 11% on the value &gt; 2,250,000 ZAR</td>
</tr>
<tr>
<td>&gt;10m</td>
<td>933,000 ZAR + 13% on the value &gt; 10m ZAR</td>
</tr>
</tbody>
</table>
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% after 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, less an exempt amount, which is currently 3.5m 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 30m ZAR 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.

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 immovable 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 2m 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.

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 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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All information used in this content, unless otherwise stated, is up to date as of 31 July 2018.
Real Estate Tax Summary – Spain

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 €1m 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 €1m if higher (50%/25% if net turnover exceeds €20m/€60m).

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 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.

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. 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 €1m (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.
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 taken into account, as will be 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.


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, 21% between €6,000 to €44,000, 23% for gains above €50,000. 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. 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.

**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 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 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 \textit{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 type 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, 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 \textit{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 recovery of input-VAT, 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**

**Corporations in Spain**

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 €9m.

The minimum equity of real estate investment funds is €9m.

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 €2.4m.

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 fulfill 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 €5m. 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 €2m 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 taken into account 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 and minimum 25% paid up of each share. For an S.L., the requirement is €3,000 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.

New transfer pricing rules are applicable for tax periods starting as of December 2006. 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. 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 €1m shall be treated as tax deductible. This means that the 30% capping only applies to amounts exceeding the €1m threshold.

• The €1m 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 type 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 June 26 ("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, provided that a prior written agreement exists, showing the method of distribution of the expenses under rational criteria; 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.

- 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. 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, no business tax shall be charged under this concept.

Taxpayers with an annual turnover under €1m (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, 21% between €6,000 to €44,000, 23% for gains above €50,000.

*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, i.e., 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

2018
All information used in this content, unless otherwise stated, is up to date as of 16 July 2018.
Real Estate Tax Summary – Sweden

General

A foreign corporate investor may invest in Swedish property directly or through a local company, ie, aktiebolag (AB), a non-resident company, or through a partnership, ie, handelsbolag/kommanditbolag (HB/KB).

Foreign investors frequently invest in Swedish property through either a resident or a non-resident holding company structure, eg, a holding company owning shares in one or more subsidiary companies.

Competitive corporate taxes

The Swedish corporate income tax rate is 22% (21.4% in 2019). The effective tax rate may be lower due to the possibility of deferring taxation of 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, eg, banks or affiliated companies (see below for 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. New EBITDA-based interest limitations will also apply as from 1 January 2019 (for further information please see below).

Group consolidation

Each company within a group constitutes a separate taxable entity. The group, as such, is not taxed. However, the group relationship is taken into account in various ways. The most obvious example is the special tax regime concerning group contributions. Group contributions entail a straight transfer of profits between group companies, a transfer 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 group tax relief 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 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, eg, to allow companies the possibility to carry back losses to offset previous years’ profits, since Swedish tax legislation does not contain a specific loss carry back provision. The reserve is based on a company’s annual taxable income. One-quarter of the taxable income may be set off to this reserve. 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 be able to carry on its balance sheet an untaxed income reserve, equal to the sum of one-quarter of each of the last six years’ taxable income. A taxable income, amounting to 72% of the government borrowing rate at the year prior to the financial year, is calculated, based on the ongoing balance of the reserve each year. The government borrowing rate should be calculated to a minimum of 0.5%.

**Interest stripping limitation**

The first regulations limiting interest deduction were introduced on 1 January 2009. Since then, strengthened rules came into force as of 1 January 2013. These rules apply in respect of interest expenses on any loan within an affiliated group, regardless of the purpose of the loan arrangement.

A minimum 10% tax test at the true creditor level, ie, the person entitled to the interest, will still allow interest deduction (measured as if the interest had been the sole income). This exception does not apply if the achievement of considerable tax benefits for the group was the main reason behind the debt structuring.

Interest within an affiliated group is still deductible by companies such as life insurance companies and pension funds to the extent that the interest rate does not exceed 250% of the average government borrowing rate the year before the income year.

Commercial reasons for the loan are still also an alternative test for allowing deduction, but only if the creditor is resident within the European Economic Area (EEA), or in a tax treaty jurisdiction with which Sweden has a full tax treaty.

For internal share acquisitions, the commercial reasons test requires both the share transfer and the debt to be based on commercial reasons.

Regarding upcoming changes in respect of interest deductibility, please see below.

**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.

**Witholding 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 concluded between Sweden and the other country.

The implementation of the general anti-avoidance 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.

In autumn 2017, the Swedish government initiated an investigation to review the above-mentioned WHT Act. The investigator will particularly analyse if the current WHT Act needs to be adapted to the relevant EU legislation, and analyse the function of the anti-avoidance provision compared to the separate Swedish tax evasion legislation. The result of the analysis is to be presented by 15 December 2018.

**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.

**Tax losses carried forward**

Tax losses can be carried forward indefinitely by a Swedish AB. Such losses may be lost if the company is liquidated, takes part in a merger, or is subject to a change in ownership. Tax losses carried forward will not be lost if the actions taken are only a matter of internal reorganisation. The tax losses can be offset against taxable income in other Swedish group companies through a group contribution, provided that the companies have the same ultimate parent who holds more than 90% of the shares and no restrictions against such utilisation apply.

**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 business conducted on the premises is subject to VAT and the premises are let during a permanent time, i.e., one year. 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, e.g., 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**

A person owning real property at the beginning of the income year is liable to pay an annual property tax based on an assessment value, which should equal 75% of the estimated market value of the property. It is common practice that the property tax for the year when a property is sold is allocated between the buyer and seller of a property.

The tax rate is 1% for commercial office space and 0.5% for industrial property. The annual property tax on properties for residential purposes is 1,337 SEK/flat (for 2018) maximised to 0.3% of the assessment value. Should one property consists of different types of premises, then the owner of the property shall pay property tax for each type of premise respectively, in proportion to their share of the total tax assessment value.

**Changes to tax law**

**Interest stripping rules**

On 21 March 2018, the Swedish government presented its proposal for new tax regulations for the corporate sector to the Council on Legislation. The new regulations were approved by the Swedish government in June 2018 and will be introduced with effect from 1 January 2019.

The new limitation on interest expense deduction implies that the EU Directive against tax avoidance and OECD’s recommendation against BEPS will be implemented in the Swedish tax law. The main legislative change can briefly be summarised as follows:

A new general limitation on the right of deduction is to be introduced for negative net interest in the corporate sector. When calculating the net interest expenses, it will be possible to offset any interest income against external interest expenses (interest income and expenses are offset against each other and any net expense is subject to the new rules). Non-deductible interest attributable to intra-group loans will not be included when calculating the net interest expenses.

The right of deduction will be based on a so-called EBITDA (earnings before interest, taxes, depreciation, and amortisation) rule. This means that a company’s net interest expenses are deductible up to 30% of the taxable EBITDA result.

Companies having net interest income can be able to deduct another company’s non-utilised net interest expense against their own net interest income. A condition for this is that the companies can exchange group contributions to each other under the Swedish tax consolidation rules, and that both of the companies report the deduction in their respective income tax returns.

Companies have the possibility to use an allowance of 5m SEK, which implies that a negative net interest up to 5m SEK within a company group will not be covered by the proposed EBITDA rule.
Negative net interest which is not deductible according to this EBITDA rule is to be carried forward during a period of up to six years. Interest expenses carried forward can, however, not be used to set off a net interest income in another group company.

For loans in a foreign currency, any exchange losses can be seen as an interest cost, and exchange gains as an interest income.

Some costs relating to financial leasing charges will be treated as interest income. The depreciation rules for leased assets are, however, not to be changed.

The new rules will not replace the current interest deduction limitation rules. Instead, the new rules will be added to the rules that are already in place. The current interest deduction limitation will, however, be narrowed in scope, and only apply in specific cases where the structure/debt relationship is specifically tax driven.

**New corporate tax rate**

The corporate tax rate will be decreased in two stages. From the current 22% to 21.4% in 2019, and to 20.6% in 2021.

**Tax-exempt transfers of real estate**

On 30 March 2017, a special group assigned to review the possibility of transferring properties by share deals in a tax-neutral way issued their proposal. The main proposal can briefly be summarised as follows.

When a property company is sold (according to the suggested legislation; when the controlling influence of a property company ceases), the property company is considered as having disposed of the property and then acquired it for market value, thus, being forced to pay taxes on a fictive transaction (market value - tax residual value = taxable gain at the rate of 22%). The fictive transaction implies a step-up on the value for tax purposes. The proposed rules are not intended to be applied on intra-group transfers/reorganisations, but on external transactions.

The property company will also need to report a standardised income to compensate for not having to pay stamp duty tax, as it would have been the case, if the property was directly disposed.

The government has received heavy criticism from the consideration parties in respect of both from a tax burden perspective as well as from a tax technical perspective. It is now up to the Ministry of Finance to decide on whether to abolish the proposal or present a final bill in the current or amended form. To date, the Ministry of Finance has not made any statements indicating in which direction the government will go with the proposal. We do, however, not expect any changes within the near future.

**Other legislative changes**

A so-called 'basic depreciation' will be introduced for apartment houses for costs incurred by a new construction, in making additions to existing buildings, and in the reconstruction of buildings. For these costs, a depreciation of 12% in total can be made during the first six years from the time when the construction work was completed. Such deprecations are to be made in addition to the current depreciation rules.

Rules against so-called 'hybrid mismatch arrangements’ are to be introduced to prevent international tax planning.
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 limited liability companies (AB’s) or limited partnerships (HB’s or KB’s) 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 is the most common alternative used for investments in Swedish real estate. Most objects available for sale on the market consist of property owning AB’s or HB/KB rather than “naked” real property. The main reason for this setup is that transactions of the latter kind 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 50,000 SEK. The AB is taxable on its corporate income at 22% (21.4% in 2019). 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 HB’s. 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, the 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 has to 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-avoidance 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.

In autumn 2017, the Swedish government initiated an investigation to review the above-mentioned WHT Act. The investigator will particularly analyse if the current
WHT Act needs to be adapted to the relevant EU legislation, and analyse the function of the anti-avoidance provision compared to the separate Swedish tax evasion legislation. The result of the analysis is to be presented by 15 December 2018.

**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 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.

**Treaty status**

There are tax treaties in place between Sweden and more than 90 countries. A Swedish AB is the most common legal entity and as such all double tax treaties are applicable to an AB. Considering that an HB is a partnership and that it is taxed in the hands of its partners, the application of double tax treaties 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 22% (21.4% in 2019). 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 22% (21.4% in 2019), 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. 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 6 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.


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All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Switzerland

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 a 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 a 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 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 24.2%, 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.

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).
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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 (e.g., community of property between spouses, family members, heirs) or by contract (e.g., 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 (e.g., 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 'Restriction 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.
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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 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.

**Regulatory aspects**

**Implications of the Federal Collective Investment Scheme Act**

As of 1 January 2007 the Federal Collective Investment Scheme Act (CISA) entered into force in Switzerland and was partially revised in 2013. Under this Act the range of legal forms available for collective investment schemes was enlarged by transparent fund vehicles such as SICAVs and limited partnerships for collective investments in addition to the already available contractual collective investment schemes.

Real estate funds are subject to investment restrictions. CISA and the related ordinances define the permitted real estate fund investments. In principle, eligible investments include both direct and indirect real estate investments.

The real estate fund with indirect real estate investments is generally transparent for tax purposes. A real estate fund with direct real estate investments is treated as opaque for the income derived from the real estate investment.

A SICAF on the other hand is regarded as opaque for tax purposes, and is always taxed as a corporate entity.

A transparent fund vehicle with a direct holding of a Swiss real estate may achieve a favourable taxation, eg, for Swiss individual investors since the income derived from the Swiss real estate is taxed with a preferential tax rate for income tax purposes at the level of the transparent fund vehicle.

**Regulatory developments regarding the Federal Collective Investment Scheme Act**

The regulatory authority for the collective investment schemes and the fund management companies as well as managers of collective investment schemes is the Swiss Financial Markets Authority ‘Eidgenössische Finanzmarktaufsicht’ (FINMA).

Since the revision in 2013, CISA is now in line with international standards, especially the European Directive 2011/61/EU on Alternative Investment Fund Managers (AIFMD), which increased the protection of investors and strengthened
the competitiveness of Switzerland as a fund location. In particular, the areas of management, custody and distribution of collective investments have been adapted.

The requirements with regard to distribution and institutions in connection with collective investment schemes are regulated by the CISA. From 2020 the Swiss Financial Services Act FSA and Swiss Financial Institutions Act FinIA will set down the requirements regarding the distribution activity and financial institutions in connection with collective investment schemes and converge its standards again towards the European regulations, especially the European Directive 2014/65/EU on markets in financial instruments MiFID II.

**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 0.03% and 0.3% and is in general calculated on the market value.

**Depreciation**

Provided it is spread across the expected life time 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.
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For commercial buildings, office and bank buildings as well as department stores:

- On buildings alone where capitalised separately 4%
- On buildings and land together 3%

For factory buildings, warehouses and workshops:

- On buildings alone where capitalised separately 8%
- On buildings and land together 7%

For hotel and restaurant premises:

- On buildings alone where capitalised separately 6%
- On buildings and land together 4%

The rates are halved if a straight-line method is used, ie, the basis of depreciation is the origin acquisition value.

**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 (restrictions may apply, eg, in the canton of Zurich). 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 from 1 January 2001, 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 taxes 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.

**Withholding tax 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 1m 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, the income realised from
the dividends is only partially taxed. If shares are held as business assets, 50% of dividends after allocable cost will be taxed. If shares are held as private means, 60% of dividends will be taxed. Several cantons have also introduced similar rules for cantonal/communal taxes (e.g., in the canton of Zurich).

**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 3.5%. 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 funds

General

A real estate fund is a ‘collective investment scheme’ and can appear in different forms. Swiss real estate can be held directly or indirectly by a SICAV (investment companies with variable capital), a SICAF (investment companies with fixed capital), a contractual collective investment fund (FCP or ‘vertraglicher Anlagerfonds’) and a KGK (limited partnership for collective capital investments). Currently, there are no Swiss SICAFs holding real estate. Swiss KGKs holding real estate investment are very rarely authorised by the Federal Financial Market Supervisory Authority (FINMA). Furthermore, Switzerland does not have a REIT regime. Hence, the subsequent comments are mainly based on the legal forms of SICAV and FCP.

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

2018
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All information used in this content, unless otherwise stated, is up to date as of 31 July 2018.
Real Estate Tax Summary – Taiwan

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.

A new real property transfer tax (RPT) regime in Taiwan has taken effect starting from 1 January 2016. As a result of the implementation of the new RPT regime, the Specifically Selected Goods and Services Tax (commonly referred to as ‘Luxury Tax’) will no longer be levied on sales of land or building starting from 1 January 2016.
Real Estate Investments – Taiwan

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. Prior to the 2018 income tax reform, Taiwan had adopted an imputation tax system, whereby individual resident shareholders receiving dividends or earning distribution are able to claim tax credit from CIT (including undistributed earnings surtax) paid against their individual income tax liability. However, the imputation tax system has been abolished in the recent 2018 income tax reform. Consequently, starting from 1 January 2018, individual shareholders can no longer claim corporate income taxes paid as credit against their individual income tax liability. The income tax reform contains a grandfather clause allowing non-resident individuals and corporate shareholders to claim 50% of the 10% surtax levied on undistributed current year earnings as tax credit against their dividend withholding tax for any dividends distributed before 1 January 2019.

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%), with entitlement 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% effective from FY2018. 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 at the same rates as Taiwanese resident companies on Taiwan-sourced income only, 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.

\[
\text{AMT} = \left(\frac{\text{Alternative minimum taxable income}}{\text{AMT exemption}}\right) \times \text{AMT rate}
\]

<table>
<thead>
<tr>
<th>AMT rate</th>
<th>AMT exemption</th>
</tr>
</thead>
<tbody>
<tr>
<td>Business enterprises</td>
<td>12</td>
</tr>
<tr>
<td>Resident individuals</td>
<td>20</td>
</tr>
</tbody>
</table>

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 dollar amount of the related party transactions fall below the safe harbour rule thresholds, the taxpayer may choose to replace the transfer pricing report with other evidentiary documents that provide proof the pricing of the transactions are at arm’s length.

On 13 November 2017, the MOF, in response to the recommendation put forth by OECD’s BEPS Action 13, amended the domestic transfer pricing regulations to introduce the 3-tier transfer pricing documentation requirement, effective from 2017. In addition to the currently required transfer pricing report, corporations will also need to provide a Master file and a Country-by-Country-Reporting file, unless the safe harbour rules for 3-tier TP documentation established by the MOF apply.

**Rental income**

Rental income is assessable and taxed at the CIT rate of % 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 are 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 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 real property tax regime:

<table>
<thead>
<tr>
<th>Item</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Taxation scope</td>
<td>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”):</td>
</tr>
<tr>
<td>- building;</td>
<td></td>
</tr>
<tr>
<td>- building and land where the building is situated thereon; and</td>
<td></td>
</tr>
<tr>
<td>- land eligible for being granted a construction permit.</td>
<td></td>
</tr>
<tr>
<td>Exclusions:</td>
<td>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:</td>
</tr>
<tr>
<td>- building or land was acquired prior to 2 January 2014; or</td>
<td></td>
</tr>
<tr>
<td>- building or land was acquired on or after 2 January 2014, but</td>
<td></td>
</tr>
<tr>
<td>before 1 January 2016, and has been held for over two years.</td>
<td></td>
</tr>
</tbody>
</table>

¹ The old real property tax 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 Real Property Tax 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.
Tax base Proceed 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:
- 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:

<table>
<thead>
<tr>
<th>Item</th>
<th>Old regime</th>
<th>New regime</th>
</tr>
</thead>
<tbody>
<tr>
<td>Scope of taxation</td>
<td>Land: exempt Building: taxable</td>
<td>Land: taxable Building: taxable</td>
</tr>
<tr>
<td>Tax base</td>
<td>Sales price ./. cost ./. expenses</td>
<td>Sales price ./. cost ./. expenses ./. tax base of LVIT</td>
</tr>
<tr>
<td>Tax rate</td>
<td>Resident Enterprise: 20% Individual: 5-40%</td>
<td>Enterprise: 20% Individual: 15%-45%*</td>
</tr>
<tr>
<td></td>
<td>Non-resident Enterprise: 20%</td>
<td>Enterprise: 35% or 45%*</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Individual: 35% or 45%*</td>
</tr>
</tbody>
</table>

* depending on holding period
**Interest expense**

Interest expense is allowed as the 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 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 the 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 is calculated based on useful lives prescribed in the Table of Service Lives 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 activities in relation to sales and acquisitions is 6% on the government-assessed value of the property. In case of a sale, the 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 revitalise 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 was increased from 20% to 21% as part of the 2018 income tax reform. The increased rate shall apply to dividends distributed to non-resident individuals and corporate shareholders from 2018 onwards. 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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Real Estate
Going Global
Thailand

Tax and legal aspects of real estate investments around the globe
2018
All information used in this content, unless otherwise stated, is up to date as of 20 July 2018.
Real Estate Tax Summary – Thailand

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 5m Thai baht (THB) and with income from the sale of goods and the rendering of services within the accounting period not exceeding THB 30m, are subject to reduced rates of tax as follows:

<table>
<thead>
<tr>
<th>Net profits THB</th>
<th>Tax rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>0 to 300,000</td>
<td>0</td>
</tr>
<tr>
<td>300,001 to 3,000,000</td>
<td>15</td>
</tr>
<tr>
<td>3,000,001 or more</td>
<td>20</td>
</tr>
</tbody>
</table>

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, e.g., 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.

There is no group taxation in Thailand.

**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 pre-paid, 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.

In certain circumstances, the transfer of real property is not subject to specific business tax 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 by 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 from 22 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 stamp duty and SBT.

In addition, a transfer of real property is not subject to the SBT if the property is sold to, or sold by the Property Loan Management Organisation, or limited companies set up by financial institutions under the law in order to manage property loans with the approval of the Bank of Thailand, or the property is sold by the Property Fund (Type I fund), Property Fund for resolving financial institution problem (Type II fund), or Property and Loan Fund (Type IV fund).

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.
Other relevant taxes

Current local taxes

House and land tax is payable by owners of a house, building, or structure and land, which is rented or otherwise put to commercial value. The rate is 12.5% of the assessed annual lease value of the property.

Stamp duty is levied at the rate of 0.1% on the rental value over the period specified in a lease contract.

Local development tax is based on the value of land (excluding improvements) and ranges from 0.25% to 0.95%. 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 house and land tax.

Proposed local taxes

Land and building tax

The House and Land Tax Act and the Local Development Tax Act are to be revoked and replaced by a new Land and Building Tax Act. A draft of the new law was approved by the Thai Cabinet on 21 March 2017 and has been under consideration by the National Legislative Assembly. To date, the legislation has not been issued.

Under the proposed land and property tax, the following natural and legal persons are subject to tax:

- individuals and juristic persons that own land or immovable property;
- individuals and juristic persons that possess or obtain a benefit from the land or immovable property owned by the State;
- owner of apartments/condominium units.

The proposed land and property tax applies to the following categories of immovable property:

- land;
- buildings;
- condominium units.

The tax base is the total value of land and immovable property calculated from the appraised value under the Land Code.

The draft act provides for a maximum rate of tax for land and immovable property in different usage. There are also rates at which it is currently proposed the tax will be collected:
<table>
<thead>
<tr>
<th>Usage</th>
<th>Maximum tax rate</th>
<th>Proposed tax rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td>%</td>
</tr>
<tr>
<td>Agriculture</td>
<td>0.15</td>
<td>0.01 – 0.1</td>
</tr>
<tr>
<td>Main residence valued over THB 50m</td>
<td>0.5</td>
<td>0 – 0.1</td>
</tr>
<tr>
<td>Commercial, industrial or other</td>
<td>1.2</td>
<td>0.02 – 0.1</td>
</tr>
<tr>
<td>Vacant land</td>
<td>3</td>
<td>0.3 – 0.7</td>
</tr>
</tbody>
</table>

**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 are 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, e.g., 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 THB 50m or more; or
- property development projects having a value of THB 50m or more.

**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 THB 500m. 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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Real Estate
Going Global
The Netherlands

Tax and legal aspects of real estate investments around the globe

2018
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All information used in this content, unless otherwise stated, is up to date as of 27 September 2018.
Real Estate Tax Summary – The Netherlands

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 Vennootschap, 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 2018, the Dutch Government presented the Tax Plan 2019, containing a number of important changes and amendments to the Dutch tax legislation for 2019 and onwards. We refer to these new proposals to the extent important. It should be noted that these proposed changes and amendments are still 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% (2018). Profits up to €200,000 are taxed against a reduced corporate tax rate of 20% (2018). On Budget Day 2018, the Dutch Ministry of Finance announced changes in the statutory corporate income tax rates. The corporate income tax rate will be reduced to 22.25% (2019: 24.3%, 2020: 23.9% and 2021: 22.25%). The step up rate for profits up to €200,000 will be reduced to 16% (2019: 19%, 2020: 17.5% and 2021: 16%).

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. Further there is a limitation on interest paid on loans that is deemed to finance participations that qualify for the participation exemption. There is also a restriction on the deductibility of interest on loans taken up for the acquisition of shares in a company that is included in the fiscal unity of the acquiring entity. The last two mentioned interest-capping rules are proposed to be abolished as of 2019.
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. Further there is no tax on the repatriation of Dutch source real estate income of a non-resident tax payer.

As per 2019 an earnings-stripping rule will be introduced, limiting the deduction of net-interest expenses in excess of 30% of a tax payers tax-earnings before interest, taxes, depreciation and amortisation (EBITDA). Refer to the section ‘Earnings-stripping rule as per 2019’ 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.

**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 depreciated on a straight line basis over 30 years.

Tax depreciation of investment 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 freehold and free of lease. As a result, the WOZ value of commercial real estate may be lower than the fair market value. Depreciation of other immovable property (buildings employed in a trade or business), is restricted if the tax book value falls below 50% of the WOZ value. On Budget Day 2018, the Dutch government has announced to increase the restriction of “other immovable property” to 100% of the WOZ value eliminating the difference with investment 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 Dutch 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 tax treaty 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%). It has been proposed to abolish the Dutch dividend WHT as per 2020. At the same time, a specific WHT will be introduced on dividends paid to shareholders in certain low tax jurisdictions and in situations of abuse.

The participation exemption is not applicable on distributions of profit that have been tax deductible at the level of the subsidiary company.
Loss carry forward

In principle, the carry forward of tax losses is limited to nine years. Tax losses can be carried back one year. Losses carried forward can be offset against future net rental income, and capital gains. On Budget Day the Dutch government has announced that the loss carry forward period may be limited to six years (instead of nine years) for losses incurred in book years commencing on or after 1 January 2019.

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). Various exemptions are available. The most important ones are the exemptions in case of a legal (de)merger or internal 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 (VAT)

As a main rule, the supply and lease of property is VAT-exempt. There are, however, two important exceptions to this general rule. The first exception is that the supply of new property or property under development (including a building site) before, on, or ultimately two years after the day the property was first put into use, is subject to VAT. The second exception is that, under certain conditions, parties can jointly opt for a VATable supply/lease of property. Such an option can be, under certain conditions, included in the notarial deed of transfer/lease agreement or else must be made by way of a request filed with the Dutch tax authorities. In case of a VATable supply/lease, the applicable VAT rate is 21% (2018). An option for VATable lease/supply is only possible in case of use of property for at least 90% for activities that permit VAT recovery by the recipient. It may often prove beneficial to opt for a VATable supply/lease, since this would allow the supplier/lessor to recover the input VAT incurred upon the acquisition or development of the property.

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.
Preface

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/NV company is subject to a flat corporate tax rate of 25% (2018). On profits up to €200,000, a reduced corporate tax rate of 20% applies (2018). On Budget Day 2018 the Dutch Ministry of Finance announced changes in the statutory corporate income tax rates. The corporate income tax rate will be reduced to 22.25% (2019: 24.3%, 2020: 23.9% and 2021: 22.25%). The step up rate for profits up to €200,000 will be reduced to 16% (2019: 19%, 2020: 17.5% and 2021: 16%).

The basis of the taxable income of a BV/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. Please see section ‘Financing the acquisition of Dutch Property’ for an outline of Dutch regulations on the limitation of interest deduction.
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 (i.e., 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 3.3% 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 investment property is no longer allowed when the tax book value (i.e., 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 freehold and free of lease. As a result, the WOZ value of commercial real estate may be lower than the fair market value. Depreciation of other immovable property (buildings employed in a trade or business), will be limited if the tax book value falls below 50% of the WOZ value. On Budget Day 2018, the Dutch government has announced to increase the restriction of “other immovable property” to 100% of the WOZ value eliminating the difference with investment 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.
Loss compensation rules

Losses relating to the property can be offset against any other taxable income generated by the BV/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 nine years. On Budget Day 2018, the Dutch government has announced that the loss carry forward period may be limited to six years (instead of nine years) for losses incurred in book years commencing on or after 1 January 2019.

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 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 of 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 51.95% (2018, 51.75% in 2019). 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 25% (2018 and 2019). Finally the income tax regime of Box 3 is applicable to savings and investments of a private individual (including shares [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) 2.02% (2018, 1.94% in 2019) for the total value of net assets from € 0 to € 100,008 4.33% (2018, 4.45% in 2019) for the total value of net assets from € 100,008 to € 1,008,000 5.38% (2018, 5.60% in 2019) for the total value of net assets exceeding € 1,008,001

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 2018 an amount of €30,000 (the same amount applies for 2019) 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 51.95% in 2018, and 51.75% in 2019). 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.

**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’.
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 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 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 6 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, i.e., the supply of goods or services.

VAT rate

The general VAT rate is 21% (2018 and 2019).

Supply of property

For Dutch VAT purposes, the supply of property qualifies as a supply of goods.
The general rule is that the supply of property is VAT-exempt. In that case, no VAT is due with respect to the supply of the property.

There are three important exceptions to this general rule.

- The supply of newly developed or redeveloped building, which takes place before, on or not more than two years after, the day it was first put into use, is always subject to VAT.

- The supply of a building site (special criteria apply).

- Any other supply of property becomes subject to VAT if parties opt for a VATable supply. 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 eg, beneficial ownership of the property) does not take place by notarial deed. For both cases this application (option) can only be made if the buyer rightly declares that it will use the property for purposes which, in principle, allow at least 90% recovery of input VAT.

- The supply of property can also qualify as a transfer of a going concern. Provided certain conditions are met (the property should be leased out and the lease should be continued by the purchaser), the transfer will not be treated as a supply for VAT purposes, so no VAT should be charged. However, this is not possible for sale and lease back.

It may often (but not always) prove beneficial to opt for a VATable supply. The advantage of such an option is that the seller retains or acquires the right to recover the input VAT paid when acquiring or having built the property. Furthermore, the input VAT on the costs that are directly used for the VATable supply can then be recovered. If the purchaser can fully (or almost fully) recover the input VAT on the supply, they will probably not object to the option.

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.

With respect to the recovery of input VAT on the purchase, building costs and maintenance costs relating to the property, the following should be noted.

- If the property is fully used for VATable activities (eg, VATable lease, see further below), the input VAT with respect to this property can, in principle, be recovered.

- If the property is fully used for VAT-exempt activities (eg, VAT, exempt lease, see further below), the input VAT with respect to this property can, in principle, not be recovered.

- If the property is both used for VATable and VAT-exempt activities, the recovery of input VAT with respect to this property is determined by calculating the proportion between the VATable and total activities: the VAT recovery
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percentage. In principle, this VAT recovery percentage is calculated on a turnover basis. In practice, however, parties or the tax authorities may use other methods to determine the VAT-recoverable percentage with respect to property, for example the ‘square metre’ ratio.

Under the so-called Dutch VAT revision rules, the (non)recovery of input VAT on the purchase (and in some cases also on the building costs) of a property is monitored for nine of the buyer’s book years following the book year of the purchase or first use (the so-called revision period). This means that when there is a change in the use of the property during this revision period, either an additional VAT payment must be made to or the owner of the property will receive an additional VAT refund from the tax authorities. Please note that there are very specific rules with respect to this subject.

In the same way as a transfer of the full title to property, a transfer of beneficial ownership of property is considered as a supply for VAT purposes. The transfer of the beneficial ownership usually includes a transfer, whereby the buyer bears the risks of all changes in value, of complete loss, and all income and expenses. Hence, the seller transfers all benefits from, and interest in, the property to the buyer with the exception of the legal ownership.

If pursuant to the transfer of the beneficial ownership the legal ownership to the property is also transferred, then this is not considered another transfer for VAT purposes and is, therefore, not taxable. The same goods cannot be transferred twice to the same person.

Please note that the creation, transfer, amendment, waiver and termination of rights to which a property is subject (eg, right of usufruct or a long lease) will be deemed to be a supply of property (excluding mortgage and rent charges), provided that the value of the reimbursement for these rights is not less than the fair market value of the property. In the case where the reimbursement is less than the fair market value of the property, the creation, transfer, etc of the right is treated as a supply of services for VAT purposes (the letting of property, see further below).

Lease of property
According to the Dutch VAT Act, the lease of property is, in principle, a VAT-exempt service. As an exception to this general rule, parties can opt for a VATable lease. The advantage of such an option is that the lessor can then recover the input VAT on costs with respect to this property. Please note that there are other specific exceptions as well.

It is possible to integrate an option in the lease agreement, provided that the following conditions are fulfilled:

- The lease agreement clearly states that the lease will be VATable. The lease agreement also specifies the commencement date thereof.

- Appended to the lease agreement (or included in the body of the lease agreement) is a signed declaration in which the lessee declares that the property will be used for purposes giving them the right to at least 90% recovery of input VAT.

- The lease agreement contains a full description of the property, information about where it is situated, and relevant land registration particulars, as well as the date of commencement of the lessee’s financial year.
• All documentation of the aforementioned is retained in the lessor’s administration.

The VAT option in the lease agreement can have a retroactive effect of three months as a maximum.

If a lessor leases parking space together with the property to a single lessee, the VAT regime applicable for the parking spaces, in principle, follows the VAT regime for the property. Hence, if the building is let VAT-exempt, the letting of the parking space will also be VAT-exempt. Please note that there are possibilities to let the lease of the parking places VATable and to safeguard the VAT recovery for VAT paid on the development and/or acquisition of parking spaces.

The Dutch VAT, which is due on supplies and services rendered by a foreign entrepreneur to a Dutch entrepreneur or a Dutch public body, is levied upon the Dutch recipient of the supply or service (reverse charge mechanism).

**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 (the ‘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 2018 is 1 January 2017. 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 taken into account. 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 2018 is determined on the basis of market prices on the reference date 1 January 2017.

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 per 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 2018. 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 approximately 0.13% of the total value for the tax year 2018. The average owner tariff for non-residential real estate for the real estate tax is approximately 0.24% of the total value for the tax year 2018. 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 taken into account. For users of non-residential real estate the average tariff for the year 2018 is approximately 0.18% 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 €710.68 (2018).

Landlords of homes in the regulated sector must pay a levy of 0.591% on the WOZ-value of these homes. This percentage shall be decreased with 0.03% to 0.561% in 2019. 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 (until 2018, this threshold amounted to 10).

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/NV company owning property are acquired by another Dutch BV/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/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/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/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/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 nine years (this carry forward period is proposed to be 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/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 tax treaty 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/NV) and no specific abuse situation applies. The Dutch dividend WHT rate may also be reduced under the double tax treaties concluded by the Netherlands.
The current 15% dividend WHT is proposed to be abolished per 1 January 2020. Concurrent to the abolishment of the dividend WHT, a new WHT for dividend payments to low-tax or non-cooperative jurisdictions where the recipient holds a qualifying interest in the distributing entity, or in case of abuse, is proposed as from 1 January 2020. It is furthermore announced, that the conditional WHT will be extended to interest and royalty payments to low-tax or non-cooperative jurisdictions where the recipient holds a qualifying interest in the payer, and in specific cases of abuse. The tax rate will be equal to the regular corporate income tax rate.

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.

Personal income tax

The income of Dutch individuals is allocated to three 'boxes'. Each of these boxes has a separate tax treatment (see 'Personal income tax' of section 'Direct investments in Dutch property').

Resident individuals

Dutch resident individuals who hold, alone or together with their spouses, 5% or more of the shares in a BV/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 25% tax rate (2018). 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/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/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/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 2018 the percentages ranges between 2.02 and 5.38% (see section ‘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/NV company will also be considered the holder of a substantial interest and will be considered a non-resident tax payer for Dutch personal income tax purposes. Non-resident substantial interest holders are, in principle, subject to the tax rate of 25% (Box 2, refer above) applicable on dividends, capital gains, etc, similar to Dutch resident substantial interest holders. Tax treaties may limit the right for the Netherlands to levy Dutch income tax on substantial interest income and gains.

The 15% (withholding) tax on dividends, which may be limited under the tax treaties concluded by the Netherlands to the reduced treaty 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/NV company to these shareholders. The WHT rate may be reduced under a tax treaty.

The Netherlands do not levy any WHT on capital gains realised by non-resident individual shareholders on the sale of the shares in a Dutch BV/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 an 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.

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 taken into account 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 the shares in a BV/NV company owning Dutch property is not subject to VAT (outside the scope of VAT). 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.

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/NV company, is that while often providing for limited liability (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/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/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 ‘Personal income tax’ of section ‘Direct investments in Dutch property’).

**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 ‘Personal income tax’ of section ‘Direct investments in Dutch property’).

**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. 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 ‘Real estate transfer tax’ of section ‘Acquisition of a Dutch property company’) 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, reference is made to paragraphs ‘General’ to ‘Property tax’ of section ‘Direct investments in Dutch property’.
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.

In the Tax Plan 2019 as presented on Budget Day 2018, the Dutch Government has announced that, in order to protect the Dutch tax base on income and gains from Dutch real estate, FBIs will no longer be allowed to invest in Dutch real estate directly as from 2020. As a result, income from Dutch real estate investments held by listed and non-listed real estate funds (such as REITs) will become subject to Dutch corporate income tax against the statutory rates.

Consequently, directly owned real estate investments can no longer be pooled in an FBI, but instead should be pooled either in a tax transparent vehicle or via a corporate entity that is subject to the ordinary income tax regime. The FBI regime as such will not be abolished, but only directly investments in real estate assets will no longer be allowed.

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 debtors 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 tax payers.

**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.

Restriction on deduction of excessive participation interest
The Dutch Corporate Income Tax Act (CITA) restricts deduction of interest on loans of which the purpose is (deemed) to finance participations qualifying for the participation exemption. The non-deductibility applies to the participation interest that is considered ‘excessive’. The excessive participation interest is the interest that can be allocated to the participation debt. The participation debt is determined by a mechanical, mathematical rule according to which the taxpayer is assumed to have financed its participations with equity first. A qualifying expansion of investments in participations are excluded provided certain conditions are met.

Interest expenses (both related party interest and third party interest) are not deductible to the extent these expenses are deemed to relate to the financing of participations (hereinafter: ‘excessive participation interest’) and to the extent the excessive participation interest exceeds a threshold of €750,000. The excessive participation interest equals the fraction (average participation debt/average total debt) multiplied by the total interest expenses. Average is to be understood as the average of the debt at the beginning and at the end of the financial year. The participation debt equals the difference between the average cost price of the taxpayer’s participations and the taxpayer’s average equity for tax purposes. The total debt is the sum of the taxpayer’s interest bearing debts. The cost price of the participations is calculated as the acquisition price of the participations increased by subsequent capital contributions to the subsidiaries and decreased by subsequent repayments of capital by the subsidiaries. The restriction on the deduction of participation interest only regards participations to which the participation exemption applies.

A transitional rule applies to participations acquired in financial years starting on 1 January 2006 or before.
Due to the introduction of the EBITDA interest deduction limitation rule per 2019, the excessive participation loan rule will be abolished (refer to section ‘Earnings-striping rule as per 2019’ below).

**Interest on acquisition debt within a fiscal unity**

The deduction of interest due by a parent company on debt used to finance the acquisition of subsidiaries included in the fiscal unity (hereinafter: ‘acquisition interest’, ‘acquisition debt’ and ‘tainted subsidiaries’) may be restricted. The restriction applies to both third party acquisition debt and related party acquisition debt if and insofar as the deduction of the interest has not already been restricted by other Dutch tax provisions.

As a general rule, acquisition interest may not be offset against profits of tainted subsidiaries. That restriction, however, only applies to ‘excessive acquisition interest’. In the year a tainted subsidiary is acquired, acquisition debt is regarded as excessive if and to the extent such debt exceeds 60% of the acquisition price. During the subsequent seven years the percentage is reduced by 5% per year. After seven years the part of the acquisition debt that exceeds 25% of the acquisition price is regarded as excessive.

Excessive acquisition interest that cannot be deducted in any year, may be carried forward and will be deductible from untainted profits in subsequent years.

Due to the introduction of the EBITDA interest deduction limitation rule per 2019, the acquisition interest deduction limitation rule will be abolished (refer to section ‘Earnings-striping rule as per 2019’ below).

**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 it 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 creditors’ 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 as per 2019
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 rule restricts the deduction of net borrowing costs to 30% of the taxpayer’s tax-EBITDA. On Budget Day 2018, the Dutch government issued a legislative proposal regarding the Dutch implementation of the ATAD.

As of 2019, net-interest expenses in excess of 30% of taxpayers EBITDA will generally be non-deductible for Dutch corporate income tax purposes. A threshold of € 1m of net-interest expenses will be deductible, regardless of the taxpayers 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.

Concurrent with the implementation of the generic EBITDA interest deduction limitation, several existing interest deduction limitation rules will be abolished. These will be the interest deduction limitation for excessive participation debt (article 13l Dutch CITA) and the interest deduction limitation for acquisition vehicles (article 15ad Dutch CITA). The interest deduction limitation with respect to base erosion (article 10a Dutch CITA) remains unchanged and will not be abolished.

VAT
The financing of property with a (mortgage) loan is VAT-exempt.

Withholding tax
The Netherlands do currently not levy WHT on interest payments, with the exception of certain hybrid debts. However, concurrent to the abolishment of the dividend WHT, a new WHT for dividend payments to low-tax or non-cooperative jurisdictions where the recipient holds a qualifying interest in the distributing entity, or in case of abuse, is proposed as from 1 January 2020. It is furthermore announced, that the conditional WHT will be extended to interest and royalty payments to low-tax or non-cooperative jurisdictions where the recipient holds a qualifying interest in the payer, and in specific cases of abuse.
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Turkey

Tax and legal aspects of real estate investments around the globe

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All information used in this content, unless otherwise stated, is up to date as of 19 July 2018.
**Real Estate Tax Summary – Turkey**

**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.

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, i.e., 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 12,000 TRY (approximately €2,160 at the current exchange rate).

Capital gains calculated as such are taxed at progressive tax rates varying between 15% and 35%.

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 sales (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.

Within the scope of the latest legislation amendments, VAT implementation for the delivery of the houses and commercial units which are subject to 18% VAT, is updated and decreased to 8% until 31 October 2018.

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% (reduced to 1.5% until 31 October 2018) 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% (reduced to 3% until 31 October 2018).

**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 2,135,949.30 TRY (approximately €384,163 at the current exchange rate; subject to annual revaluation) for the year 2018. Each and every signed copy of an agreement is subject to stamp tax.
**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 30m TRY for the year 2018.

**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 (34,000 TRY or approximately €6,115 for the year 2018). Declared income will be subject to income tax at the progressive rate between 15% and 35%.

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 1m TRY (approximately €179,856) 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 10m 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 Tax Summary – Ukraine**

**Legal considerations**

A foreign investor may purchase Ukrainian property either directly or through a local company. However, there is a requirement for foreign individuals to rent out premises in Ukraine 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).

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 due to the 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 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 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 attracts stamp duty at a 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.
Special Pension Fund charge of 1% applies to 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**

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.

**Beneficial ownership**

The Ukrainian Tax Code prescribes the ‘beneficial ownership’ test that needs to be satisfied in order to claim exemption/reduced WHT rate under the relevant double tax treaty.
Legal aspects

General considerations

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, ownership of a real estate is governed by Ukraine Civil Code, Ukraine Land Code, Ukraine Commercial Code, Law of Ukraine on State Registry of Property Rights, etc.

Ownership rights to real estate are subject to state registration. 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 has also to be registered by the Land Cadastre.

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 the state registration.

A foreign corporate or individual investor may acquire real estate either directly or via a local company.

Real estate (land) ownership

Effective as of 1 January 2002, foreign individuals and companies may acquire only non-agricultural land within territory of settlements or outside territory of settlements where 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.

Agricultural land cannot be owned by foreign citizens, stateless persons, foreign companies, or foreign states.
From 1 January 2019, the law on turnover of the agricultural land will come into force. The law generally prohibits: (i) contribution of ownership share for the land plot into the share capital of companies; (ii) sale of the state and municipal agricultural land, and (iii) disposal and change of the designated purpose of the land plots used for agricultural commodity production and private agricultural household.

Generally, a foreign legal entity may purchase state 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 land from a relevant municipal council, subject to the consent of the Cabinet of Ministers of Ukraine. To purchase state or municipal land, the foreign entity must set up a commercial representative office in Ukraine.

As a general rule, state and municipal 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 complex reconstruction of old residential districts and some other cases.

Ukrainian individuals and companies can acquire ownership of agricultural land with a total area of up to 100 hectares. This area may be increased in case of inheritance of the land plot by law.

These restrictions apply to foreign individuals and foreign companies.

**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 the 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 collect 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 thin capitalisation rule, depreciation of goodwill and fixed assets not engaged in business activity, payments to offshore jurisdictions, etc).

Taxpayers whose prior year annual income equals to or less than 20 million Ukrainian hryvnia (UAH), approx. US$750,000, 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. 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.

**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 four depreciation methods available: straight-line, accelerated reduction of a residual value, cumulative, and reducing balance. The Tax Code sets a minimum period of 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%. 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**

Payment of dividends to non-resident shareholders attracts 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. 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.

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 due to the 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 standard CIT rate of 18%.

Under Ukrainian domestic law, income realised by a non-resident company from 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.

Profits earned by a foreign shareholder on the sale of shares in a Ukrainian company are subject to the 15% WHT. Most of the double tax treaties provide an exemption from the Ukrainian WHT in such cases, unless the shares in the Ukrainian company derive their value principally from immovable property located in Ukraine.
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 the 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 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 from sales of immovable property located abroad is subject to a standard 18% rate plus 1.5% military tax, irrespective of tax residency status.

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 a 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 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 attracts stamp duty at a 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 corporate entity or individual, purchase of real estate (except for land plots) attracts a pension fund charge at the rate of 1% of the real estate value.

The Civil Code requires mandatory notarisation of contracts for 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 US$35.

Contract for lease of land may be notarised, which attracts 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 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 on indexation rate. If there is no normative valuation of the land plot the taxpayer should apply normative valuation of the square meter of land in the respective region.

The rate of land payment for land owners 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 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 land owners 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 a 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;
- 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 2018, the maximum is 55.84 UAH per square metre (approximately US$2.1 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 possesses one or more objects of residential property with the total area of one asset more than 300sqm (for an apartment) or 500sqm (for a house), the amount of tax is increased by 25,000 UAH (approximately US$940) 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

2018
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Real Estate Investments – United Kingdom

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 by the Real Estate team of PwC LLP, to provide an introduction to the UK tax and legal regimes 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, VAT, transfer duties and other real estate taxes. A legal summary and glossary of legal terms are included at the end of the 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.

Land and Buildings Tax (LBTT) replaced UK SDLT in Scotland from 1 April 2015, and Land Transaction Tax (LTT) replaced 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.

In respect of Stamp Duty Land Tax (SDLT), the top rate applying to acquisitions of UK 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’ purchasers, and individuals who are not replacing a main residence.
The March 2016 Budget announced changes relating to trading in UK land, and restrictions on interest deductibility and loss relief.

These changes relating to trading in UK land fall into four categories:

1. Extending UK corporation tax to non-UK 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 permanent establishment in the UK). The intention is to tax all non-UK 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).

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.

Restrictions for UK companies in respect of interest relief and carried forward losses were also introduced from April 2017.

The interest relief restrictions were introduced in accordance with the OECD’s BEPS project and the starting point is to restrict finance cost deductions to 30% of tax EBITDA. There is also a £2m de minimis and the option of using an alternative group ratio or a public infrastructure exemption if this will provide a better result.

The loss restriction limits to 50% the amount of profit against which brought forward losses in excess of £5m can be offset.

There are also proposed (but not yet enacted) changes.

It is proposed that capital gains on non-resident disposals of UK property will be brought within the scope of UK tax from April 2019. This will apply to gains on direct and indirect disposals.

In addition, it is proposed that from April 2020 income that non-resident companies receive from UK property will be chargeable to corporation tax (rather than income tax). This means that the restrictions on interest relief and the carry forward of losses referred to above will also apply to non-resident corporate landlords.

**Investment in real estate directly by non-resident investors**

**UK tax on rental income**

Non-residents who receive rental income from direct investments in UK real estate are, typically subject to UK tax under the income tax regime.
A corporation that is not resident in the UK for tax purposes, and not carrying on a trade in the UK through a permanent establishment (PE), is subject to basic rate UK income tax at 20% on net income from the rental business. Most other types of organisations, with the exception of certain types of trusts, are taxed in the same way.

In 2018/2019 an individual is subject to basic rate income tax at 20% on net taxable income up to £46,350, and then to higher rate income tax at 40% on net income falling between the limits of £46,350 to £150,000. An additional rate of 45% applies on net taxable income in excess of £150,000.

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 specialised area and is not covered in this guide.

Ownership of real estate

There are no significant legal differences in the way that corporations and individuals, UK resident or otherwise, may hold real estate in the UK. However, no more than four persons, whether individuals or corporations, 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 greater detail see section ‘Legal summary and glossary of terms’.

Basis of assessment

The period of assessment is the tax year that runs from 6 April of one year, to 5 April of the following year. Rental income is taxed by reference to the profits of the UK rental business.

The results of this business are determined in accordance with commercial accounting principles. All rental income is aggregated and taxed on an accrual basis. Expenditures, including interest, are deductible on the same basis as expenditures relating to a trade (see section ‘Allowable expenses’).

Where tax has not been deducted at source from rental receipts (see section ‘Withholding tax and self-assessment’), a non-resident landlord will be required to make two payments on account of income tax based on the previous year’s tax liability. The first instalment is payable by 31 January during the year of assessment, and the second instalment is payable by 31 July following the year of assessment. Any balance is payable by 31 January following the year 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.

**Withholding tax and self-assessment**

Where a non-resident landlord applies to HMRC, 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 Taxes Acts (see section ‘Allowable expenses’ below), and no relief can be given for expenses, for example interest paid directly by the landlord.

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.

**Tax returns where rent is received under deduction of tax**

A non-resident corporation is not obliged to file an income tax return where the agent or tenant has withheld income tax from the rents. However, as noted above, a non-resident landlord can elect to file a 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 individual is required to notify HMRC if they are chargeable to UK tax at the higher rate within six months of the end of the year of assessment in which
the chargeable income arises. In the past, HMRC has not generally attempted to claim the excess of the higher rate tax over the basic rate withholding tax. However 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 and self-assessment' above, against the rental income if the individual submits a 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.

**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.

**Interest payments**

Interest is 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 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 4 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 is being 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 will be no deduction allowed in respect of the finance costs.

Instead, income tax payers 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-UK 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 to reduce or eliminate the withholding tax. Current HMRC practice in this area suggests that interest paid by a non-UK borrower will not usually
have a UK source, unless the borrowing is primarily enforceable in the UK. 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.

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.

**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:

- A 18% allowance a year, using the reducing balance method, on plant and machinery in industrial or commercial buildings.

- A 8% 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.

- A 8% 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.

- A 100% first year allowance (FYA) is available on certain eligible expenditure, including environmentally beneficial plant and machinery, and designated energy-saving technology and products. A tax credit is also available to encourage start-up and other loss-making companies, at a rate of 19% of the loss surrendered, within prescribed limits.

- An annual investment allowance (AIA) provides individuals, certain partnerships and companies with an annual 100% allowance for the first £200,000 of expenditure 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 in respect of a trade (ie, not property investors) in a limited number of designated Enterprise Zones.

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.

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.
From 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. From April 2014, in certain cases a buyer may not be 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 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.

**Permanent establishment**

A non-resident company has historically only been subject to UK corporation tax if it carried on a trade through a permanent establishment (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 carries 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-UK 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, FA 2016 extended the corporate tax regime from 1 April 2017 to trading profits attributable to a trade of dealing in or developing UK land (irrespective of
whether there is a UK PE). The intention is to tax all non-UK traders in UK land on the whole of their profit wherever it arises.

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 ‘Basis of assessment’) but is calculated for the accounting period of the company (see section ‘Period of assessment’). However, relief for interest is given separately (see section ‘Interest payments’).

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 offset 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.

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 carried forward without time limit to be used to offset income and gains earned in future accounting periods.

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 income at the normal corporation rate which, for the year 1 April 2017 to 31 March 2018 is 19%.

A further 2% reduction is proposed from 1 April 2020, resulting in a main rate of corporation tax of 17%.

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.

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 an Inland Revenue 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, 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 threshold referred to above is reduced to take into account associated companies. There are special rules where companies cross this threshold.

**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.

**Interest payments**

Interest is deductible on an accrual basis, subject to the restrictions outlined below. Where the loan is undertaken for the purposes of a property 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 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. See section ‘Trading in real estate’ for a discussion of the distinction between trading and investing 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.

From April 2017, interest is also subject to the corporate interest restriction introduced in accordance with the OECD’s 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 GBP £2m 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.

**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 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 REITs (see ‘UK real estate investment trusts (REITs)’).

**UK real estate investment trusts (REITs)**

Real estate investment trusts (REITs) are a type of tax transparent property investment vehicle in the UK, similar to certain types of property investment vehicles in other countries (eg, US real estate investment trusts). 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 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 CTA 2010 (which 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 5 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 double tax treaty, 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 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.

• From 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 to treat the restriction as taxable income.
• 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 double tax treaty. 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.

Tax treatment of investors in a REIT

A distribution from the tax-exempt profits of a REIT 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 Double Tax Treaty.

Shareholders are not entitled to a tax credit on receipt of the distribution but any income tax deducted may be repayable in appropriate circumstances.

The receipt of a distribution from the tax-exempt business of a REIT is treated as a separate business from any other property income or UK property business that the shareholder may have but receipt of distributions from different REITs are treated as receipts of the same business.

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). Although the practical uptake has been slow, PAIFs may in the future play a major role in developing the real estate market. They introduce a new dimension, effectively an unlisted REIT, which puts the UK on a similar footing to the US and other jurisdictions that benefit from this status. It means that investment in a PAIF would be similar to direct investment in property.

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.

Greater detail is given in the last 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 and used by the owner to carry on a trade other than one of real estate dealing/development.
- 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. A non-resident investor will not be subject to UK tax on chargeable gains unless the investor carries on a trade in the UK through a PE, and the real estate is connected with, or held for the purposes of, the PE. However, where a non-resident company is controlled by five or fewer persons, and if any of those persons are UK-resident, then their share of the gain will be taxable in the UK.

In addition, non-UK resident investors are subject to UK tax on certain residential property gains under the non-resident gains tax (NRCGT) regime, and both UK and
non-UK investors are subject to the ATED gains regime in respect of certain residential property gains.

**ATED**
Since April 2013 UK residential property worth more than £2m in April 2012 and owned through an ‘enveloped structure’ (i.e., 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 £1m from April 2015 and to £500k from April 2016.

Any post 5 April 2013 capital gains realised on the disposal of enveloped properties are subject to CGT at 28%.

The ATED rules apply to certain non-natural persons – ‘NNPs’, including: companies (UK and non-UK 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.

**NRCGT**
UK residential property disposed of by certain non-residents since 6 April 2015 has been within the scope of UK CGT by virtue of the non-resident CGT charge (‘NRCGT’). The non-residents affected include individuals, trustees, the personal representatives of non-resident deceased persons and ‘narrowly controlled’ companies.

NRCGT covers gains realised post 6 April 2015 and the rate is 20% for companies and 28% for trustees. Individuals are 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 apply to companies owning UK residential properties (see below), the ATED charging provisions take precedence over NRCGT.

NRCGT does 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) are outside the scope of charge.

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’).

Capital losses made on disposals of real estate can only be used to offset chargeable gains made in the same period or future periods. Excess capital losses can be carried forward without time limit. The offset of capital losses against chargeable gains may be restricted in certain cases, e.g., 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.

**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.

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-UK 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 permanent establishment in the UK). The intention is to tax all non-UK 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 is preferable for the UK investment activities to be carried on in a separate company that does not carry on any real estate trading activities.

**Capital allowances**

A disposal will often lead to a recapture of capital allowances previously claimed by the seller.

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.

**Computation of chargeable gains**

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 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 £10m, sold three years later, and the UK retail price index increases by 10% during the period, the indexation allowance would be £1m.

The indexation allowance can only reduce a capital gain to nil. It cannot create or increase a capital loss.

**Rollover opportunities**

Chargeable gains, arising on real estate where the real estate is acquired for a business other than dealing, developing or investing in real estate, 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.
Sale of shares in a UK real estate company

Gains made on the sale of shares in a UK real estate company by a non-resident investor, who is not carrying on a trade in the UK through a PE, have normally been exempt from UK tax.

However, there are anti-avoidance provisions which mean that the gain can be treated as income in certain circumstances where the underlying property has been acquired or developed with a trading motive. These are the "transactions in UK land" provisions referred to above. 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.

The indirect disposal provisions will apply, broadly, to disposals of shares or other assets which derive at least 50% of their value from land where the person making the disposal is party to an arrangement concerning the development of the land.

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.

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 (VAT)
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 a year (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
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− United Kingdom

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. Certain alterations to protected buildings to be used for qualifying residential purposes are also zero-rated.

VAT is chargeable on supplies of real estate as follows:
### Transaction type

<table>
<thead>
<tr>
<th>Transaction type</th>
<th>VAT treatment</th>
<th>VAT rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction of residential buildings.</td>
<td>Zero-rated</td>
<td>0</td>
</tr>
<tr>
<td>Qualifying conversion and renovation works on residential buildings.</td>
<td>Reduced rated</td>
<td>5</td>
</tr>
<tr>
<td>All other works on residential buildings.</td>
<td>Standard-rated</td>
<td>20</td>
</tr>
<tr>
<td>The first-time sale, including leases exceeding 21 years (in Scotland, leases of no less than 20 years) of:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(a) a new residential building by the person who constructed it</td>
<td>Zero-rated</td>
<td>0</td>
</tr>
<tr>
<td>(b) a substantially reconstructed listed residential building by the person who substantially reconstructed it</td>
<td>Zero-rated</td>
<td>0</td>
</tr>
<tr>
<td>(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</td>
<td>Zero-rated</td>
<td>Nil</td>
</tr>
<tr>
<td>Sale (other than the first sale) of a residential building</td>
<td>Exempt</td>
<td>0</td>
</tr>
<tr>
<td>Other leases in residential buildings</td>
<td>Exempt</td>
<td>0</td>
</tr>
<tr>
<td>Construction of non-residential buildings</td>
<td>Standard-rated</td>
<td>20</td>
</tr>
<tr>
<td>Repair and maintenance of any buildings</td>
<td>Standard-rated</td>
<td>20</td>
</tr>
<tr>
<td>Sale of freehold interest in a new non-residential building</td>
<td>Standard-rated</td>
<td>20</td>
</tr>
<tr>
<td>Sale of an existing (ie, not new) non-residential building</td>
<td>Exempt/Standard-rated</td>
<td>0/20</td>
</tr>
<tr>
<td>Grant of a lease in a non-residential building</td>
<td>Exempt/Standard-rated</td>
<td>0/20</td>
</tr>
</tbody>
</table>

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 land transactions at the rate of 5% of the VAT-inclusive consideration to the extent that the consideration exceeds £250,000 only (rather than to the entire consideration). Reduced rates apply in respect of consideration up to £250,000.

For residential transactions, SDLT is payable at the relevant rate to the extent that the consideration falls within the bands as follows:

<table>
<thead>
<tr>
<th>Purchase price £</th>
<th>Rate %</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 125,000</td>
<td>0</td>
</tr>
<tr>
<td>Over 125,000 and up to 250,000</td>
<td>2</td>
</tr>
<tr>
<td>Over 250,000 and up to 925,000</td>
<td>5</td>
</tr>
<tr>
<td>Over 925,000 and up to 1,500,000</td>
<td>10</td>
</tr>
<tr>
<td>Over 1,500,000</td>
<td>12</td>
</tr>
</tbody>
</table>
From 1 April 2016, however, an additional 3% is 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.

Where the additional 3% applies, the SDLT rates are:

<table>
<thead>
<tr>
<th>Purchase price</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>£</td>
<td>%</td>
</tr>
<tr>
<td>Up to 125,000</td>
<td>3</td>
</tr>
<tr>
<td>Over 125,000 and up to 250,000</td>
<td>5</td>
</tr>
<tr>
<td>Over 250,000 and up to 925,000</td>
<td>8</td>
</tr>
<tr>
<td>Over 925,000 and up to 1,500,000</td>
<td>13</td>
</tr>
<tr>
<td>Over 1,500,000</td>
<td>15</td>
</tr>
</tbody>
</table>

There are also rules which mean that the acquisition of individual residential dwellings priced over £500,000 by a company or non-natural person will be subject to a flat rate of SDLT at 15% in certain circumstances.

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 and £5m and at a rate of 2% on the net present value of the total rent over £5m.

For a residential lease, SDLT is payable at a rate of 1% on the net present value of the total rent over £125,000.

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 1%), rather than their aggregate value. (This relief does not apply to residential dwellings that are individually priced at £2m 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 15% where the additional 3% for second homes or buy-to-lets applies), and up to 4.5% 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 £1.5m (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 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 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. For more detailed information please contact the Business Rates team.

The NNDR is based on a multiplier, which is set each financial year (commencing 1 April) by central government. For 2017/18 the standard multipliers are 49.3% for...
large businesses and 48% for small businesses. Large properties are defined as those with a rateable value of £51,000 or above. The 2017/18 multiplier in Wales is 51.4%, 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). 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 2021 (using 1 April 2019 as the reference point for the tax) and after that revaluations will occur every three years.

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 will pay no rates at all, while qualifying ratepayers with rateable values between £12,000 and £15,000 will receive tapered relief from 100% to 0%. There is a buffer zone between £15,000 and £51,000 where eligible ratepayers’ bills are calculated using the small business multiplier.

In Wales, qualifying ratepayers with rateable values below £6,000 pay no rates at all, and a taper applies for rateable values between £6,001 and £12,000.

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. The Business Rates team will be able to advise you as to those reliefs currently available.
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 a 100% empty rates charge applies.

All unoccupied properties with rateable values of less than £2,600 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. For more detailed information, please contact the Business Rates team.

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.

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.

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–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 will apply to all lettings already in place.

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 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 10 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.
  - 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
Types of finance
Finance for the purpose of acquiring and/or development of real estate is usually obtained in one or more of the following ways:

- Equity, or direct investment. This may take the form of an unsecured and subordinated loan by an investor or shareholder to the company.
- Bank loan.
- Securitisation/bond issue, which is suitable for very large properties, or portfolios of properties.

Security
The following types of security are available to the lender:
• A mortgage or charge, giving the lender control over the charged assets and the rights of an absolute owner over property should the borrower default.

• Qualifying floating charge (see section ‘Enforcement of security’ below).

• A guarantee, whereby another person or company undertakes to repay the loan if the borrower does not.

• A debenture, which is a mortgage over property and fixed and floating charges over the borrower's other assets.

• A rent account charge, whereby rental income from a property is paid into a bank account which is then charged to the lender.

**Taking security**

It would be usual when taking up security to carry out a due diligence exercise comprising the following:

• Investigating and checking the title ownership of the security provider to any land to be mortgaged.

• Checking the constitutional documents of the security provider and borrower.

• Checking the terms of leases to which a property is subject to ensure these are institutional.

• In development situations, checking the terms of construction documentation and any pre-let agreements.

• Undertaking searches at the appropriate registries to check whether there are any prior charges.

• 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 prior to 15 September 2003 were not affected by the new legislation. The comments below summarise the changes made.

**Lenders**

If the borrower fails to meet its loan obligations, then depending on the nature of the security, the lender has the following options:

• Take possession and claim the income under any leases from tenants.

• Appoint an administrator, liquidator or receiver, for company borrowers, or for individual borrowers, trustee in bankruptcy and ultimately sell the property on the open market and use the proceeds of the sale to repay the loan.

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, making this type of receivership more expensive for the lender.

Under the Act, a lender can no longer appoint an administrative receiver unless an exception applies. The exceptions listed include arrangements through which a single project company incurs debts of £50m in which the lender has ‘step-in’ rights to take control of the project. There is also an exception for urban regeneration projects and public–private partnership projects if the lender in each case has step-in rights.

The Act introduced a new out-of-court route into administration, in addition to the existing court application procedure. A majority of the directors will be able to appoint an administrator after providing notice to lenders. 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. The purpose of administration under the Act is to rescue the company, either as a going concern or through returning greater value to the creditors as a whole than would be achieved in liquidation. Lenders no longer have the right to prevent the appointment of an administrator.

A liquidator is appointed by the company itself, or by its creditors, when it wishes to cease business and realise all of its assets. A trustee in bankruptcy will be appointed by the court to realise the assets of an insolvent individual.

Order of payment for creditors
Following the sale of the assets of the business, the proceeds will be distributed in this order:

- secured creditors;
- preferential creditors;
- proceeds of ring-fenced assets to creditors as a whole; and
- other non-secured creditors.

Ring-fencing
A specific percentage of the company’s net property (which is the net proceeds of property subject to a floating charge) 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.

Preferential creditors
The Act removed the preferential status of Crown debts, such as UK tax and VAT, but preserved them for certain employee obligations including contributions to an occupational pension scheme.

Secured creditors
Excluding preferential creditors and ring-fenced assets, a security holder is entitled to the sale proceeds of the secured assets ahead of other creditors. The problem arises 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 creditors as a group.

**Method of enforcement**

Administration is the most frequent method of enforcement under the Act. To benefit from the advantages of the administration procedure and to avoid the disadvantages (i.e., the inability of security holders to resist the appointment of an administrator), security holders may wish where possible to structure transactions so as to benefit from an exception that will allow them to appoint an administrative receiver. It is essential that where a full security package is taken, that it be structured so as to include a qualifying floating charge under the Act.

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.

**Glossary of terms**

The following expressions are commonly used in respect of real estate law in England and Wales:

<table>
<thead>
<tr>
<th>Term</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alienation</td>
<td>The transfer of an interest in a leasehold property, which includes an assignment, underletting, charging of an interest or parting with occupation or possession.</td>
</tr>
<tr>
<td>Apportionment</td>
<td>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.</td>
</tr>
<tr>
<td>Beneficial interest</td>
<td>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.</td>
</tr>
<tr>
<td>Best rent</td>
<td>The highest rent that can reasonably be expected by a landlord in the circumstances of a particular case.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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<tr>
<td>---------------</td>
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</tr>
<tr>
<td>Betterment</td>
<td>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.</td>
</tr>
<tr>
<td>Break clause</td>
<td>A clause in a lease which gives the landlord and/or tenant a right to terminate the lease before its contractual expiry date.</td>
</tr>
<tr>
<td>Building scheme</td>
<td>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.</td>
</tr>
<tr>
<td>Capitalisation</td>
<td>The conversion of a series of net receipts over a period into the equivalent capital worth.</td>
</tr>
<tr>
<td>Commonhold</td>
<td>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.</td>
</tr>
<tr>
<td>Common land</td>
<td>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.</td>
</tr>
<tr>
<td>Completion</td>
<td>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.</td>
</tr>
<tr>
<td>Consideration</td>
<td>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.</td>
</tr>
<tr>
<td>Contract</td>
<td>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.</td>
</tr>
<tr>
<td>Covenant</td>
<td>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.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Curtilage</td>
<td>The ground that is used for the enjoyment of a building.</td>
</tr>
<tr>
<td>Damages</td>
<td>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.</td>
</tr>
<tr>
<td>Dilapidations</td>
<td>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.</td>
</tr>
<tr>
<td>Disregards</td>
<td>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).</td>
</tr>
<tr>
<td>Easement</td>
<td>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.</td>
</tr>
<tr>
<td>Engrossment</td>
<td>The formal and final version of a legal document, prepared by a solicitor for signature, once the contents have been negotiated and agreed.</td>
</tr>
<tr>
<td>Fixture</td>
<td>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.</td>
</tr>
<tr>
<td>Forfeiture</td>
<td>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.</td>
</tr>
<tr>
<td>Headlease</td>
<td>A lease held directly from the freeholder, which may be subject to one or more underleases.</td>
</tr>
<tr>
<td>Indexation</td>
<td>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.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Land Registry</td>
<td>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.</td>
</tr>
<tr>
<td>Latent defect</td>
<td>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.</td>
</tr>
<tr>
<td>Licence</td>
<td>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.</td>
</tr>
<tr>
<td>Lien</td>
<td>The right to retain possession of the property of another as security for the performance of an obligation, generally the payment of a debt.</td>
</tr>
<tr>
<td>Open market value</td>
<td>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.</td>
</tr>
<tr>
<td>Option</td>
<td>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.</td>
</tr>
<tr>
<td>Outgoings</td>
<td>The costs and expenses incurred by the owner or occupier of a property in connection with its ownership, use, management and maintenance.</td>
</tr>
<tr>
<td>Party wall</td>
<td>The wall separating the properties of two adjoining owners, each of which will have certain rights over the wall.</td>
</tr>
<tr>
<td>Peppercorn rent</td>
<td>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, but could literally be a peppercorn (this term has historic meaning).</td>
</tr>
<tr>
<td>Portfolio</td>
<td>Collection of properties or other investments held under one ownership.</td>
</tr>
<tr>
<td>Possession</td>
<td>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.</td>
</tr>
<tr>
<td>Term</td>
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</tr>
<tr>
<td><strong>Practical completion</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Pre-emption</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Pre-let</strong></td>
<td>A legally enforceable agreement for a letting to take effect at a future date, e.g., on the practical completion of building works.</td>
</tr>
<tr>
<td><strong>Prescription</strong></td>
<td>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 10 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.</td>
</tr>
<tr>
<td><strong>Priority of mortgages</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Quarter days</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Quiet enjoyment</strong></td>
<td>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.</td>
</tr>
<tr>
<td><strong>Rack rent</strong></td>
<td>A rent representing the full, or nearly the full, letting value of the property on a given set of terms and conditions.</td>
</tr>
<tr>
<td><strong>Sale and leaseback (or lease and leaseback)</strong></td>
<td>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.</td>
</tr>
<tr>
<td>Term</td>
<td>Definition</td>
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</tr>
<tr>
<td>Service charge</td>
<td>The amount payable by a tenant under a lease in respect of the services provided by the landlord.</td>
</tr>
<tr>
<td>Surety</td>
<td>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.</td>
</tr>
<tr>
<td>Surrender</td>
<td>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.</td>
</tr>
<tr>
<td>Zoning</td>
<td>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.</td>
</tr>
</tbody>
</table>

**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 £1m would pay rates of £493,000 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). 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 – for further information please contact the Business Rates team.

An exemption applies to all empty properties with a rateable value less than £2,900.

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. Band H is the highest, for values over £320,000 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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Real Estate
Going Global
United States of America

Tax and legal aspects of real estate investments around the globe

2018
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Real Estate Tax Summary – United States of America

General

On 22 December 2017, President Donald Trump signed the “Tax Cuts and Jobs Act” (TCJA or Act) 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. The summary below reflects the impact of the TCJA on the aspects of US tax law relevant to a foreign investor investing in US real property. Many facets of the TCJA’s application to potential structures and transactions remain uncertain in light of pending guidance from US tax authorities.

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 withholding tax (WHT) of 30%, or a lower treaty rate, on the gross amounts derived from the US real property.

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 a maximum rate for 2018 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 contained significant limitations on the ability of a US taxpayer to deduct interest expense. As such, deductions for interest on loans made or guaranteed by persons may be limited by the borrower’s financial profile, or limited if the borrower is considered thinly capitalised. Interest paid, or in certain circumstances deemed paid, to a foreign investor is generally subject to a 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 generally provides for immediate expensing by changing the deduction for assets eligible for bonus depreciation so that 100 percent 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 nonresidential 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 (MCT), also referred to as the Net Investment Income or 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 (AGI) 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 a 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 2018, 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.

Dividend withholding tax

Dividends paid by a US corporation to a foreign shareholder are subject to a 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. Dividends 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.

**Branch profits tax**

A foreign corporation that invests directly in US real estate may be subject to a BPT 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 classified as a corporation for US tax purposes is up to 44.7%. Domestic corporations are not subject to the BPT. Consequently, avoiding BPT is often an important reason why foreign corporations invest in US real estate through domestic corporations.

**Loss carryforwards**

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. Starting in 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 percent of taxable income (determined without regard to the deduction). For 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 NOL carrybacks but made NOL carryforward in perpetuity. This new 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 trusts (REITs)**

A REIT will pay no US income tax if it distributes all of its net income to its shareholders. The dividend withholding 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. A 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). 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.
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% or lower treaty rate US withholding tax (WHT) 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

Avoidance of US estate and gift tax

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. A US real property investment can be properly structured so that no US estate tax will result upon the NRA’s death.

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 2018, the maximum tax rate for US citizens or residents is 37% and for corporations is 21%.

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% withholding 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 avoiding or minimising US withholding tax 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 situations where a related foreign lender pays a reduced rate of US tax or no tax, the deduction for the interest may be limited under earnings stripping rules. The earnings stripping rules can also apply to interest paid to an unrelated lender, such as a US bank, if a foreign investor guarantees the debt.

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 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%.

**Avoiding 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 avoid 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 will not apply. However, without proper planning, the investor could then be subject to US tax.

If no distributions are made, or deemed to be made under the BPT, until all US real property owned by the corporation, other than a RIC or a REIT, 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 a 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 Real Estate Investment Trust (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 deferred until the related asset 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, i.e., 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.

Accordingly, in such cases, the rental income is not considered US business income. In addition, the mere ownership of stock normally does not constitute a business to the shareholder, even if the corporation itself is engaged in a business such as real estate rentals or development. Therefore, dividends received from the corporation do not constitute business income to the shareholder.

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 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.

**Taxation of US business income**

US business income from US real property is subject to tax at the regular US rates applicable to US taxpayers. The 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 2018 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 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 is owed at the end of the tax year by accrual basis taxpayers to related parties that use the cash basis of accounting, including foreign parties subject to US withholding tax on a cash basis on the interest income.
- 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 percent 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 nonresidential 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. It also appears, according to the Conference Report that the TCJA intended to provide that the useful life of qualified improvements would generally be 15 years. However, the language in the text does not appear to accomplish this objective.

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 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 ‘Withholding tax’.)

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
US$5m 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. However, there is a transition rule for property disposed if one leg of the exchange is completed in 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) 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 force a foreigner to accept 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 installment 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 net lease 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. A foreigner is not subject to US tax on income from sources outside of the US if the income is not connected with a US business. However, once connected with a US business, a foreigner's income, irrespective of its source, is subject to US income tax as discussed previously. Because the focus of this discussion is US income taxation of foreign investment in US real estate, a broad discussion of the source of income rules is not appropriate. It is important to note, however, that the geographical location from where income is paid, or where it is received, is irrelevant in determining its source for US income tax purposes. Specific source rules normally apply to each different type of income.

Capital gains of a foreign investor, other than from the sale of US real property interests, are generally not taxable if they are not US business income. 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 from sales occurring before the first day the individual is present in the US during the calendar year 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. The 30% WHT on gross income does not apply to them. Accordingly, all capital gains from sales after the individual is considered a US resident will be subject to the regular US income tax.
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)**

The foreign investor in US real estate is affected by the 30% WHT, not only with respect to non-business income it receives from US sources, but also with respect to US-source fixed or determinable annual or periodic (FDAP) income payments it makes to other foreigners. The foreign or domestic corporation, and in certain instances, the foreign individual, will usually be considered a withholding agent for purposes of the 30% WHT imposed on US-sourced FDAP income.

Following are some instances where either a foreign corporation or 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.
- Interest paid to foreign persons.

Failure to withhold the tax on these payments makes the payer liable for the tax and possible penalties.

**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. However, a planning opportunity is available in which the foreign shareholders hold only non-voting stock, while all of the voting stock is held by US shareholders or others not requiring the portfolio debt exemption (such as less-than-10% foreign shareholders). 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.
- 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 Internal Revenue Code 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 avoid 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 investor can use to the amount that the taxpayer has ‘at-risk’ in the investment, which includes the investor’s share of any ‘qualified non-recourse debt’ that is secured by real property.

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, i.e., regularly, continuously and substantially. However, rental activities and limited partnership investments 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 US$25,000 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 US$150,000.

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 a maximum rate of 28%, or 20% for corporations, 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 35% for corporations and 39.6% for individuals.

Note that the TCJA eliminated the AMT for corporate taxpayers beginning on 31 December 2017.

**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).
- 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 or alternative minimum 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, i.e., 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.

If a foreign corporation is not subject to BPT as a result of applicable treaty benefits, 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 a rate of 30%. Nonetheless, a treaty may eliminate the second-tier withholding if either the foreign corporation or the ultimate dividend recipient is entitled to treaty benefits.

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 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 a 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. To obtain the benefit of any US treaty’s lower rate, the beneficial owner of the interest, or in certain cases the payer foreign corporation, must be a qualified resident of the foreign country that is a party to the US treaty. The definition of
qualified resident for these purposes is the same as for purposes of the branch profits tax.

**Branch-level excess interest tax**

A third tax imposed by the branch tax provisions is 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 Internal Revenue Code 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.

**Branch-level tax and treaties**

Generally, the requirements for a corporation to be considered a qualified resident of a particular country with a US treaty for purposes of the BLT and BLIT are as follows:

- More than 50% of the value of the corporation’s stock must be owned during at least half of the tax year by residents of such country or by citizens or residents of the US. This is the stock value test.
• Less than 50% of the corporation’s income is used, directly or indirectly, to meet liabilities to persons that are not residents of such country or citizens or residents of the US. This is the base erosion test.

• The corporation must be a resident of the treaty country as defined in the treaty.

To meet the stock value test, the corporation must be able to substantiate the residence status of the shareholders in accordance with regulations.

Alternatively, if the corporation’s stock is regularly traded on an established securities exchange of the treaty country, or if it has a substantial and active business presence in such country that is an integral part of the US business, then the corporation may also be considered a qualified resident. In all cases, the corporation on which the particular BLT would be imposed, or possibly NRA, in the case of the BLT on interest paid, must also meet the particular treaty’s requirements. Some treaties, for example, have higher thresholds for the stock value and base erosion tests.

To determine which treaty, if any, applies to reduce or alter the application of the BLT provisions, one must consider the entity on which the particular BLT is imposed, and any applicable treaty language. Certain US treaties prohibit the BPT by means of their non-discrimination articles. Other treaties explicitly alter the computation and/or rate and permit the imposition of the tax. Those treaties that do not fit either of these two categories permit the tax. The IRS has published a notice of those countries with US treaties prohibiting and altering the BPT.

In addition, foreign corporations that are qualified residents of other treaty countries may be able to use a reduced BPT rate as specified by the applicable treaty.

**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 US$1,000 IRS penalty, or US$10,000 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 US$ 10,000 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 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.

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, 10% or less of such class of stock. This exception for stock traded on an established securities market applies only if the 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 work space.
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 five percent 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 QPF, or a wholly owned entity of a QPF, 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 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 that is listed on a recognised stock exchange;

• 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 Internal Revenue Code, the non-recognition provisions will apply only if the foreign investor transfers the USRPI in exchange for another USRPI, or a property interest that 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.

In an otherwise tax-free transfer by a foreign person of a USRPI to a foreign corporation as paid-in surplus or a contribution to capital, the transferor is taxable on any inherent gain in the transferred property. An exception is provided in the temporary regulations. This holds that 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 avoid 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, 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 Internal Revenue Code 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 US$300,000.

- The transferor has made a valid Internal Revenue Code 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 US$15,000 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 US$11.2m from US estate tax, the estate of an NRA is entitled to a credit equivalent to only a US$60,000 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 avoiding 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.

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 of property that is 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 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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