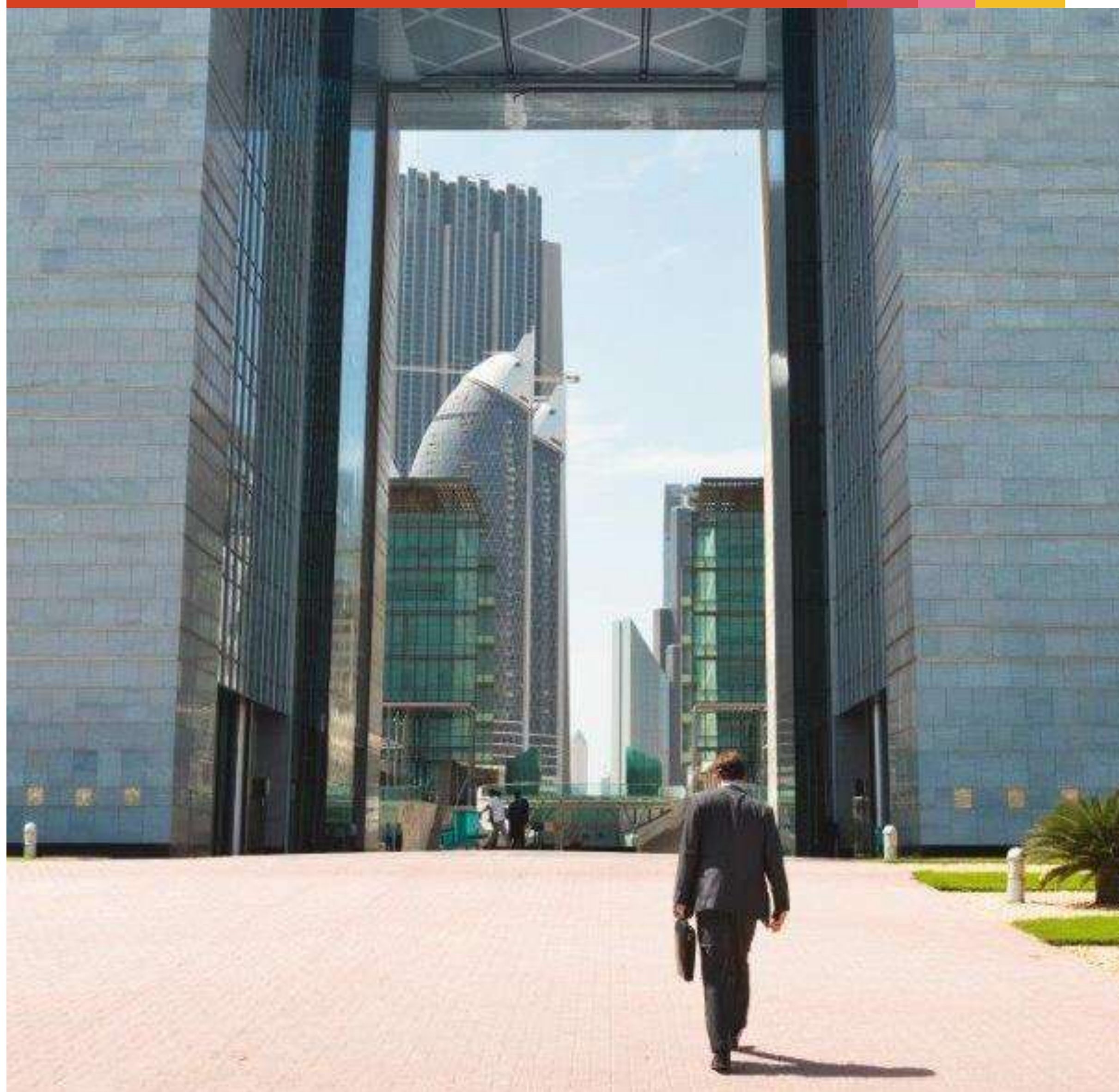
www.pwc.com/goingglobal

Real Estate Going Global

Worldwide country summaries

Tax and legal aspects of real estate investments around the globe

2016



pwc

Contents

Argentina
Australia
Austria
Brazil
Bulgaria
Canada
China
Cyprus
Czech
Republic
Denmark
Finland France
Germany
Greece
Hong Kong
India
Ireland
Israel
Italy
Japan
Luxembourg
Malaysia
Mexico
New Zealand
Norway
Philippines
Poland
Portugal
Romania
Russia
Singapore
Slovakia
South Africa
Spain
Sweden
Switzerland
Taiwan
Thailand
The Netherlands
Turkey
United Kingdom
United States of America

www.pwc.com/goingglobal

Real Estate Going Global Argentina

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Argentina 3

Real Estate Investments – Argentina 4

Contacts 8

All information used in this content, unless otherwise stated, is up to date as of 26 May 2016.

Real Estate Tax Summary – *Argentina*

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

At the national level, real estate rental income from properties located in Argentina is subject to a 35% income tax rate for legal entities and a scale based rate for residents.

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

Value added tax is applicable to rents exceeding the amount of ARS 1,500 and to construction works.

Rental incomes as well as real estate developers are subject to Gross Revenue 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.

Real Estate Investments – Argentina

Sale of shares by non-residents

On 23 September 2013, Law 26893 was published, which means that there is now a tax on capital gains arising from the transfer of shares, bonds and other securities. It also includes a tax on dividend distributions. It should be clarified that the exemption available for foreign beneficiaries (Section 78 of Decree No. 2,284/1991) on income derived from Argentine share transfer was repealed. Thus foreign beneficiaries would become 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.

Argentine entities' dividend distributions will be subject to a 10% income tax through a withholding mechanism to be applied by the distributing company. This tax is additional to the so-called "equalisation tax" (the existing 35% withholding on distributions that exceed the accumulated tax earnings of Argentine entity making 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 of the roll-over mechanism in the income tax return.

The use of real estate trust

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.

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 arm's length principle should be duly followed and documented.

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 17 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 reorganize your investment structure.

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 Exchange Currency Market (MULC). In this sense, regarding incoming flows of currency (as financial loans or capital contributions) a reduction of the minimum term for keeping in Argentina inflows of funds was established. This minimum permanence term was reduced from 365 to 120 calendar days. 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 (with certain specific exceptions) and local governments may access the MULC to purchase foreign currency without the prior approval of the BCRA for an amount not exceeding USD2m in the calendar month under certain items (real estate investments abroad, loans granted to non-residents, etc). Under specific scenarios, the mentioned calendar limit can also be exceeded.

As to payments of imports of goods, the Advance Import Sworn Statements (DJAIs) were replaced by the Integral Monitory System for Imports (SIMI). In this sense, for all final import for consumption destinations, importers must submit to AFIP the information related to the goods to be imported in the SIMI. Additionally, an Import Licensing system has been established.

For most imports of goods past transactions, a payment schedule for accessing the MULC has been set. According to this schedule, from June 2016, there will be no limitations for those payments.

There are also new procedures in force for the payment of services rendered by non-residents. In this sense, payment of services imports performed as from 17 December 2015 may be made with no limits to their amounts. Moreover, 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 Advance Services Sworn Statement (DJAS) is still required when accessing the MULC for the payment of services.

As to services imports provided and/or accrued until 16 December 2015, a payment schedule for accessing the MULC has been set. According to this schedule, from June 2016, there will be no limitations for those payments.

Although certain amendments to rules applicable to exports of goods and services are in force, it should be noted that regulations regarding the entrance of funds into the country and the obligation of exchange of foreign currency in the Exchange Market corresponding to payments of exports of goods and services remain in force.

Besides this, there are no formal restrictions on the payment abroad of interest, dividends or profits, royalties and other commercial payments duly supported by the corresponding documentation.

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 (eg, a subsidiary or a branch) may be required by the local Office of Corporations.

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

Rural land ownership law

Pursuant to Law 26,737, 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 given 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 (approximately 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.

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 over real property not personally owned, which allows its holder to use, enjoy and dispose the property subject to the right to build (or right over what is built) in relation to the said real property. Maximum legal term for this surface right is of 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.

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.

Contacts

Advisory

Marcelo Iezzi
Tel: +54 11 48506816
E-mail: marcelo.iezzi@ar.pwc.com

Assurance

Andrés Suárez
Tel: +54 11 48504690
E-mail: andres.suarez@ar.pwc.com

Tax & Legal

Ricardo Tavieres
Tel: +54 11 48506722
E-mail: ricardo.d.tavieres@ar.pwc.com

Pedro de la Fuente
Tel: +54 11 48506728
E-mail: pedro.de.la.fuente@ar.pwc.com

Lisandro Martín López
Tel: +54 11 48506722
E-mail: lisandro.martin.lopez@ar.pwc.com

Claus Noceti
Tel: +54 11 48506846
E-mail: claus.noceti@ar.pwc.com

Paula Lázara
Tel: +54 11 48506000
E-mail: paula.lazara@ar.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Australia

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Australia 3

Real Estate Investments - Australia 6

Contacts 16

All information used in this content, unless otherwise stated, is up to date as of 04 April 2016.

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 value of the property exceeds A$54m (or A$5m for heritage properties) or if the acquisition is of shares or units in an entity that is land rich. Any acquisition by a foreign government (which is widely defined), requires FIRB approval. FIRB rarely withholds approval except when the acquisition is of residential property or vacant land.

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 47% 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. 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. MIT's 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.

On 3 December 2015, Bills were introduced into Federal Parliament containing the legislation to implement the new tax regime for MITs. This new regime is expected to apply from 1 July 2016 once it is passed into law. Further information is summarised under the heading "*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 a withholding tax of 10% 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 lenders in certain countries under double tax treaties.

Australia's transfer pricing rules can also apply to loans in certain circumstances. Australia also has debt/equity rules that apply to loans.

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 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 of securities held in entities that are land rich (broadly, more than **50% of the entity's** assets is 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 10% 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 by lodging an Australian income tax return.

Real Estate Investments - Australia

Acquisition tax issues

Government approval

FIRB approval is required for any proposed acquisition of Australian real estate depending on the nature (commercial, undeveloped vacant land, etc.) and the value of the Australian real estate. The rules can also apply to the acquisition of securities in entities owning Australian real property.

An application for approval must be lodged with FIRB prior to entering into any agreements unless the agreement is conditional upon obtaining FIRB approval.

Stamp duty

The Australian states impose a stamp duty on a range of transactions, including the acquisition of real property (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 many states no longer have share transfer or mortgage duties. 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 by state).

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 (i.e. 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).

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.

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

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 and thin capitalisation provisions

Interest on borrowings used to acquire real property is deductible against rental income.

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 (i.e. third party bank debt and related party debts). Note that the transfer pricing rules are also relevant to loans and interest deductions.

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 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 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 withholding tax. The rate of withholding tax depends 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. MIT's 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.

If the AUT is not a MIT, it must withhold tax from the distributions. The rate of tax depends on the type of investor (30% if a company).

This 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. 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.

The MIT qualification requirements are summarised under the heading "*Managed Investment Trusts*".

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 under the heading "*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).

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 10% 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 by lodging an Australian income tax return.

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 imposed by each Australian state and territory and is calculated as a percentage (up to 3.7%) of the unimproved capital value of land (as assessed by the state) owned at a particular date during the year. The top marginal 2016 rates are eg, 2% in NSW and 2.25% in Victoria.

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 a 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:

- An Australian life insurance company (based on recently proposed law, this is expected to be extended to include non-Australian life insurance companies from 1 July 2014.).

- A complying Australian superannuation fund (or foreign pension fund equivalent) with at least 50 members.

- A pooled superannuation trust (PST) that has at least one member that is a complying superannuation fund with at least 50 members.

- A MIT in relation to the income year.

- A regulated foreign collective investment vehicle with at least 50 members.
- An entity, the principal purpose of which is to fund pensions for the citizens or other contributors of a foreign country if:
  - the entity is a fund established by an exempt foreign government agency; or
  - the entity is established under a foreign law for an exempt foreign government agency; or
  - the entity is a wholly owned subsidiary of an entity mentioned above.
- An investment entity that is wholly owned by one or more foreign government agencies, the entity is established using only the public money or public property of the foreign government concerned and all economic benefits obtained by the entity have passed, or are expected to pass, to the foreign government concerned.
- An entity established and wholly-owned by an Australian government agency, if the capital of the entity, and returns from the investment of that capital are used for the primary purpose of meeting statutory government liabilities or obligations (such as superannuation liabilities).
- Based on recently proposed law expected to apply with effect from 1 July 2014, the Qualified Investor definition will be extended to include an entity that is wholly owned by one or more Qualified Investors.
- Based on recently proposed law expected to apply with effect from 1 July 2014, the Qualified Investor definition will be extended to include a limited partnership where all of the limited partners are Qualified Investors and the General Partner has a 5% or less interest in the partnership.

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%.
- **MIT's** 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 new MIT Regime

On 3 December 2015, Bills were introduced into Federal Parliament containing the legislation to implement the new tax regime for MITs. This new regime is expected to apply from 1 July 2016 once it is passed into law.

There will 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 new legislation relevant to real estate investors:

- The definition of a qualified investor will be extended to include entities that are wholly owned by one or more qualified investors and limited partnerships where all the limited partners are qualifying investors and the general partner holds a 5% or less interest.
- **This change more closely aligns Australia's treatment of limited partnerships for** this purpose with other tax jurisdictions.
- This will benefit foreign collective investment vehicles or multiple qualified investors who seek to pool their funds into a single vehicle to invest into Australia and regional or global real estate funds that have an allocation to Australia.
- The current 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 new rules, 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.

- Existing and proposed trust structures in the real estate sector will need to give careful consideration as to whether it is appropriate to elect to be an AMIT. The ability to access the attribution mechanism for unitholders and that foreign trusts are now considered the final taxpayer in regards to the MIT withholding tax liability, must be considered on balance with the additional compliance costs (including a significantly expanded AMIT tax return).

Contacts

Advisory

Adam Somerville
Tel: +61 2 82662464
E-mail: adam.somerville@au.pwc.com

Assurance

James Dunning
Tel: +61 2 82662933
E-mail: james.dunning@au.pwc.com

Tax & Legal

Joshua Cardwell
Tel: +61 2 82660532
E-mail: josh.cardwell@au.pwc.com

Christian Holle
Tel: +61 2 82665697
E-mail: christian.holle@au.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
Austria

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Austria 3

Contacts 11

All information used in this content, unless otherwise stated, is up to date as of 28 April 2016.

Real Estate Tax Summary – Austria

General

A foreign individual or corporate investor may invest in Austrian property directly or through a local company, such as an *Aktiengesellschaft* (AG) or *Gesellschaft mit beschränkter Haftung* (GmbH) or a partnership.

Business income versus rental income

Generally, in Austria, income earned from the leasing of real estate will be classified as rental income. Income earned by legal entities (corporations, limited liability companies) is always classified as business income. Income earned by a local partnership is also classified as business income, provided the partnership performs business activities other than pure rental activities.

From 1 January 2006 onwards, 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

The income tax rates for non-resident individuals range from 0% on the first €2,000 of taxable income to 55% on income in excess of €1m p.a. through a progressive rate.

Foreign legal entities 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 applied (see comments below on '*ImmoInvFG*').

Rental income is measured by the excess of receipts over income-related expenses. Expenses are deductible provided they are related to Austrian real estate. The following deductions among others are allowed:

- 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.

Generally, a withholding tax (WHT) of 27.5% is levied on capital income for individuals. Only interest payments from deposits or other non-bonded receivables with Austrian banks are taxed with 25% WHT.

If the foreign corporation declares that the interest is part of its taxable profit, it will be exempt from the WHT and taxed with the general tax scale.

There are no formal debt-to-equity ratio requirements under Austrian thin capitalization rules.

Group taxation model

If two or more companies fulfil the requirements for the group taxation model and exercise the option to form a tax group, the taxable results of the domestic group members will be attributed to their respective parent company and will be taxed at the level of the group parent. As a result, tax losses of (also foreign) group companies can be consolidated with taxable profits of other group companies. The requirements for the group taxation concept are:

- A participation of more than 50% of the parent company in relation to the group members;
- A minimum duration of three years, and
- A written application to form a tax group, which has to be filed with the competent tax office.

As of 1 March 2014, foreign companies can only form part of a tax group, if an extensive administrative assistance between Austria and the respective foreign country exists.

In the case of a domestic tax group, the whole income is attributed to the parent company, irrespective of the holding quota. With regard to foreign group members, only negative income to the extent of the capital ownership percentage is attributed to the parent company. It is necessary to "recalculate" the foreign losses in accordance with the Austrian tax law requirements. The possibility to deduct foreign losses is capped with the amount actually suffered based on foreign law. As of 1 January 2015, losses of foreign group members can only be acknowledged to the extent of 75% of the taxable income in Austria. In case this limit is exceeded, the losses can be carried forward to subsequent periods. Generally, an appropriate system of tax allocations between the group companies has to be established, mainly to ensure that the minority shareholders are neither advantaged nor disadvantaged.

A subsequent taxation of losses which were not offset also occurs if and to the extent that such losses were attributed to a foreign subsidiary and the foreign subsidiary ceases to be a member of the Austrian tax group or the loss generating business unit is sold, closed down, or has materially decreased in scope since the year in which the losses were generated. According to the Austrian tax authorities, the materiality threshold requires a 75% decrease in scope.

Depreciation

Regarding income from rent and lease, the basis of depreciation includes the acquisition costs of the building, but not the value of the land. A general subdivision of the acquisition costs into 40% for the land and 60% for the building was legally fixed as of 1 January 2016 for private property. Tax depreciation must be calculated using the straight-line method, according to which the annual depreciation is a fixed percentage of cost.

As of 1 January 2016, the depreciation rates for business property were standardised with 2.5%. If a non-resident investor holds the building directly or as private property for residential purposes, the annual depreciation rate is 1.5%. A higher depreciation rate can only be applied in case of providing a corresponding expert opinion. In addition, the distribution of maintenance expenses was extended from 10 years to 15 years for private property as well as for business property.

Goodwill depreciation of domestic participations

For share deals involving an Austrian company after 31 December 2004, the goodwill including the hidden reserves in depreciable assets (eg, buildings) had to be deducted for tax purposes over a period of 15 years, subsequent to the formation of an Austrian tax group. The depreciation basis was limited by 50% of the total share purchase price.

As of 1 March 2014, the goodwill depreciation of domestic participations was abolished.

Capital gains on the sale of property

Up to 31 March 2012, capital gains deriving from the sale of real estate by non-resident direct investors (corporations or individuals) were only treated as taxable income, if they qualified as speculative gains or business income.

Business income is derived from either an Austrian PE, an Austrian permanent representative, Austrian real estate held by a non-resident corporate investor, or a non-resident individual having a business abroad.

Until 31 March 2012, capital gains of non-resident individuals, having no PE in Austria and holding the real estate as private property, were only taxable if real estate and related rights were disposed of within 10 years, or within 15 years under certain circumstances (speculative gains).

Since 1 April 2012, gains from the sale of property are subject to income tax with a special tax rate of 30% (until 31 December 2015: 25%). The tax assessment base is the profit calculated using sales price minus acquisition costs. Real estate property that is already beyond the speculation period under the old regime ("old real estate assets") are subject to special transition rules.

"Old" properties (acquisition before 31 March 2002) which were rededicated from land sites to building sites after 31 December 1987 are taxed at 18% (until 31 December 2015: 15%) of the sales price. "Old" properties without rededication are taxed at 4.2% (until 31 December 2015: 3.5%) 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 and 60% of an overhang can be offset with income from rent and lease concerning private property. 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.

Gains arising from the sale of real estate that was held for at least seven years as business property by individuals (not corporate investors) are not taxed under the condition that such gains are used to reduce the book value of fixed assets purchased or manufactured in the same year, or within the following 12 months. The minimum holding period is increased to 15 years under certain circumstances.

As of 2012, the rollover relief for the hidden reserves is only available in cases where the replacement asset is used within a domestic PE. Hidden reserves from the sale of land may only be used to reduce the valuation basis of land and buildings. Hidden reserves from the sale of buildings may only be used to reduce the valuation basis of buildings. If the reserve is not used within this 12-month period from the sale, or 24 months under certain circumstances, it has to be added back to taxable income.

Corporations are not eligible for the rollover credit system through which realised hidden reserves can be withdrawn from an immediate taxation in case of a reinvestment. Individuals who hold real estate through a partnership can still benefit from this rollover credit system.

In Austria, the sale of shares in a company whose assets mainly consist of Austrian property is not treated as the sale of the property owned by the company according to income tax With regard to real estate transfer tax, a transfer of Austrian property is assumed where an investor obtains 95% or more of the shares in a domestic property owning company (see below under the section '*Real estate transfer tax*').

Participation exemption/withholding tax on 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.

Dividends and capital gains received by a resident corporation from a foreign subsidiary in an EU Member State, a member state of the European Economic Area (EEA) or of a third- party country are exempt from corporate income tax on the basis of the international participation exemption, if the participation is at least 10% for a minimum of one year and the anti-abuse provisions are met. In addition, dividend income received from EU Member States or third-party countries with comprehensive administrative assistance is exempt, regardless of participation quota and duration, however subject to anti-abuse provisions.

Dividends and capital gains are not exempt from corporate income tax, if the focus of the foreign subsidiary is to achieve passive income from interest payments, from the sale of participations or from the allocation of mobile material or immaterial assets.

In addition, the foreign subsidiary needs to be low-taxed (currently at less than 15%) or not taxed at all abroad concerning corporate income tax.

Further, dividends from EU subsidiaries are subject to a credit system in case the EU subsidiary is taxed with less than 15%.

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

Dividends paid by an Austrian company to its domestic or foreign private shareholders are generally subject to 27.5% WHT under domestic law. Dividends paid to corporations are still subject to 25% WHT. Dividends paid to non-resident individuals are generally subject to the full WHT rate, although this rate might be mitigated or eliminated by existing double tax treaties.

Dividend payouts to corporations based in the EU are generally exempt from WHT according to the Parent-Subsidiary Directive, if the participation quota is at least 10% for a minimum of one year. Furthermore, corporations based in the EU or in a state of the EEA with comprehensive administrative assistance can apply for the refunding of the WHT paid on their obtained income in Austria, unless it is credited in the state of origin according to a DTT. This reclaim provision is applicable irrespective of the extent of participation as well as the holding period and will be of interest for corporations not fulfilling the tight prerequisites of the EU Parent- Subsidiary Directive. Moreover, a refunding of WHT can be conducted entirely or partly based on a DTT. Anti-abuse provisions apply to all refunding procedures.

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. No loss carryforwards are available for rental income.

A change on crediting foreign taxes paid for foreign sourced income taxable in Austria has taken place. Foreign taxes comparable to the Austrian corporate income tax that cannot be credited in Austria in one year, due to tax losses, may be carried forward by the Austrian company, if the Austrian company provides an accurate documentation of the economic double taxation and no foreign tax credit forward is granted to the company. Foreign WHTs can still not be carried forward.

Real estate transfer tax

A real estate transfer tax is levied on the acquisition of real estate, including buildings on land owned by third parties, situated in Austria. The tax rate is basically 3.5% of the purchase price. An additional registration duty of 1.1% is also due. If there is no purchase price (eg, gifts), or in case 95% or more (until 31 December 2015: 100%) of the shares of the asset-owning company are united in the hand of one shareholder, the taxable base as of 1 January 2016 is a newly introduced value of the property comparable to the market value. Under these circumstances, a tax rate between 0.5% and 3.5% applies.

Value-added tax (VAT)

In principle, sale, rental and lease transactions are VAT-exempt, with no input VAT credit. Rental income from residential properties is taxable for VAT purposes at the rate of 10% with input VAT tax deduction. However, rental for accommodation is taxable at the rate of 13% (until 30 April 2016: 10%) with input VAT tax credit. In the case of the sale of real estate, or rent or lease of offices, industrial premises, plants and other non-residential real estate, the supplier (ie, the lessor) may opt for taxation at a rate of 20% with input VAT tax credit. In this respect the Stability Act 2012 comes up with

restrictions for lease contracts concluded after 31 August 2012. Regarding those lease contracts, it is only allowed to opt for taxation with the possibility to deduct input VAT in case the tenant himself is performing more than 95% VAT-able turnovers. With regard to sales subject to VAT, the VAT amount forms part of the basis for real estate transfer tax.

If input VAT was credited according to the provisions of the Austrian Value-Added Tax Act, this amount has to be adjusted if circumstances decisive for input VAT tax credit change. With respect to real estate, an observation period of nine years from the year the asset has been used for the first time has to be taken into account. A change taking place within this period leads to a pro rata adjustment of one-tenth of the input VAT credited. In the course of the Stability Act 2012, the observation period of nine years has been extended to nineteen years for those properties used for business purposes for the first time after 31 March 2012. In case of lease contracts, the extended observation period applies for contracts concluded after 31 March 2012.

Reverse-charge regarding construction services

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

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

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

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

- The VAT identification number of the recipient of the services.
- Reference that the recipient of the performance is liable for the VAT payable by indicating 'reverse charge'.

Inheritance and gift tax

An individual non-resident in Austria directly owning an Austrian real estate property used to be subject to Austrian inheritance and gift tax.

In 2007, the Austrian Supreme Constitutional Court abolished the legislation with regard to inheritance and gift tax, after having declared it a violation of constitutional principles. According to this decision, the Austrian inheritance and gift tax was finally

phased out on 31 July 2008 (ie, beginning 1 August 2008, there is no inheritance and gift tax in Austria).

However, a Gift Announcement Law 2008 was published, which stipulates a compulsory obligation to notify asset transfers due to a gift transaction to the Austrian Tax Authorities. The disclosure obligations apply for securities, cash, shares in companies and tangible assets if certain thresholds are exceeded. 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 characterized by the fact that a real estate investment fund is seen as a tax-transparent vehicle with the investors being subject to tax with any income from such fund (as determined under the rules of the Austrian Real Estate Investment Funds Act) irrespective of whether a distribution has been made or not. As a result, on the level of an investor income from a (non-Austrian) real estate investment fund comprises not only actual distributions but also so-called deemed distributions.

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

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

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

(iii) certain investment income.

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

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

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

Pursuant to sec. 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, and

- Any collective investment vehicle investing in real estate which is subject to a foreign jurisdiction and which, irrespective of the legal form it is organized 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** following criteria is given:

  – 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.

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.

Contacts

Advisory

Hannes Orthofer
Tel: +43 1 501882930
E-mail: hannes.orthofer@at.pwc.com

Wolfgang Vejdovsky
Tel: +43 1 501881150
E-mail: wolfgang.vejdovsky@at.pwc.com

Assurance

Peter Pessenlehner
Tel: +43 1 501881424
E-mail: peter.pessenlehner@at.pwc.com

Tax & Legal

Rudolf Krickl
Tel: +43 1 501883420
E-Mail: rudolf.krickl@at.pwc.com

Petra Holzer
Tel: +43 1 501883043
E-Mail: petra.holzer@at.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Brazil

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Brazil 3

Real Estate Investments - Brazil 6

Contacts 14

All information used in this content, unless otherwise stated, is up to date as of 04 May 2016.

Real Estate Tax Summary – *Brazil*

1. Acquisition of 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.

2. Acquisition of rural real property

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

3. 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 either, both or one of the following:

- Income, derived from capital, labour or a combination of both.
- 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.

3.1 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 of non-resident investors.

3.2. 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* - IRPJ), a federal tax levied at 25% rate, and the Social Contribution on Net Income, or *Contribuição Social sobre o Lucro Líquido* (CSLL), a social contribution levied at 9% rate.

Additionally, **revenues of legal entities are subject to PIS (Employees' Profit** Participation Program or *Programa de Integração Social*) and COFINS (Contribuition for Social Security Financing or *Contribuição para o Financiamento da Seguridade Social*) at a 1.65% and 7.6% rate, 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.

3.3. Non-residents

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

4. Capital gains on the sale of property

4.1 Individuals

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

4.2 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 a 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* - **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.

4.3. Non-residents

Disposal of real estate properties by non-resident individuals is subject to withholding tax at a rate of 15%. As of 2017, gains recognised by non-resident investors on the sale of real estate property will be subject to 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.

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

5. 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*- ITBI*)*, based on the value of the sale or transfer.

Each municipality imposes its own ITBI rates, usually ranging from 2% to 4%.

Certain transferences (eg, capital contribution with real estate assets) may be tax exempt, provided certain conditions are met.

6. Other relevant taxes – IPTU, ITR and ITCMD

A municipal tax called Real Estate Tax, (“*Imposto sobre a Propriedade Predial e Territorial Urbana*” - IPTU) is imposed on the holding of the real estate. The tax is calculated on an appraised value of the property (not necessarily the fair market value), and rates vary from one municipality to another (on average of 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 ITR, or *Imposto sobre a Propriedade Territorial Rural*, which is a federal tax levied on the ownership or possession of rural property. The tax rate is determined considering the area size and how much the area is used (ranging from 0.03% to 20%).

The State Tax ITCMD, or ***Imposto sobre a Transmissão “Causa Mortis” e Doação de*** *Bens e Direitos*, is levied on inheritances and donations of real estate properties and their rights, and rates vary from state to state, usually 2% to 4% (maximum rate is 8%).

7. 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 – FII) or Private Equity Funds (Fundo de Investimento em Participações – 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 to verify the most tax efficient scenario.

Real Estate Investments - Brazil

1. 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.

2. 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).

3. Direct acquisition for residents

3.1. 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 is as set out in the table below (using an exchange rate of 4 BRL to $1).

Taxable basis $	Rate %	Deductible amount
Up to 475.99	Exempt	0
From 475.99 to 706.66	7.5	61
From 706.66 to 937.76	15	153
From 937.76 to 1,166	22.5	276
More than 1,166	27.5	378

* This table is valid for 2016.

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 his/her 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 is subject to 15% rate. As from 2017, gains will be subject to income tax at a progressive rate ranging from 15% to 22.5%, based on the amount of capital gain received (using an exchange rate of 4 BRL to $1):

Taxable basis $	Rate %
Up to 1,250,000	15
From 1,250,000 to 2,500,000	17.5
From 2,500,000 to 7,500,000	20
More than 7,500,000	22.5

* This table is valid for 2016.

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) $5,000 (equivalent to 20,000 BRL – using an exchange rate of 4 BRL to $1) for shares sold through the over-the-counter market; and (ii) $8,750 (equivalent to 35,000 BRL – using an exchange rate of 4 BRL to $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 is also a reduction factor applicable to the calculation basis of the capital gain on the sale of residential real estate by resident individuals.

3.2 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 a rate of 15%, with a surcharge of 10% on annual taxable income in excess of around $60,000 (using an exchange rate of 4 BRL to $1). 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 direct 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 $19.5m (using an exchange rate of 4 BRL to $1) per year. 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 means of calculating a presumed net income, over 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 9% rate.

Basically, the choice between Actual Profit Method and 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, for real estate depreciation purposes, the rate of 4% per year.

Law 11.638/2007 established new criteria for evaluation of fixed assets. For accounting purposes, the recommendation is that depreciation 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 of 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 for 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 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 is important to highlight 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, both under non-cumulative and cumulative method 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* - RET"). Under this regime, the taxes IRPJ, CSLL, PIS and COFINS are paid at a unified tax rate of 4% of the received revenues. Tax rate may be reduced to 1% if the real estate development has social purposes.

3.3. Non-residents

Rental revenues accrued by non-resident taxpayers are subject to tax on their Brazilian-source income at a rate of 15% to 25%, depending on the location of the beneficiary. Brazilian-source 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 a rate of 15%. As from 2017, gains recognised by Brazilian non-resident investors on the sale of real estate property will be subject to 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.

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.

3.4. 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, direct acquisition of real estate or incorporation of a Brazilian company) is subject to IOF at 0.38% rate.

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.

3.5. Real estate transfer tax (ITBI)

Real Estate sales/transference, carried by individuals, corporations and non-residents is subject to the ITBI (*Imposto sobre Transmissão Intervivos de Bens Imóveis*), 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.
- Any assignment of rights in connection with the aforementioned transfers.

Note that 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%.

3.6. Other relevant taxes – IPTU, ITR and ITCMD

A municipal tax called Real Estate Tax, or *Imposto sobre a Propriedade Predial e Territorial Urbana* (IPTU) is imposed on the 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, rates vary from one municipality to another, on average of 0.3% to 2.8%, depending on the type of the real estate (ie, residential or non-residential, rural or urban land), always considering the limit of 15%.

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

The State Tax ITCMD, or ***Imposto sobre a Transmissão "Causa Mortis" e Doação de*** *Bens e Direitos*, is levied on inheritances and donations of real estate properties and their rights. Rates vary from state to state, usually 2% to 8%.

4. Indirect acquisition

4.1. 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). Please refer to Item 3.2 – Corporations, for further details on the taxation of Brazilian entities.

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 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.

4.2. Indirect acquisition: Capital gains on disposal of shares in a Brazilian entity

Non-residents

Disposal of shares of a Brazilian entity by non-resident investors are subject to withholding tax at a rate of 15%. As of 2017, gains recognised by Brazilian non-resident investors on the sale of real estate property will be subject to 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.

Corporations

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

Individuals

Gains arising from the disposal shares are currently taxed at 15% rate. As of 2017, gains recognised by Brazilian individuals on the sale of real estate property will be subject to 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.

5. 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 - 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.

Non-residents

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

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

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

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

Corporations

Gains arisen from investment funds or disposal of fund quotas will be subject to corporate taxation as indicated on Section Corporate Taxes for a Brazilian Entity.

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.

Contacts

Advisory

Rogerio Gollo
Tel: +55 11 36742616
E-mail: rogerio.gollo@br.pwc.com

Renato Revoredo
Tel: +55 11 36743265
E-mail: renato.revoredo@br.pwc.com

Assurance

João Santos
Tel: +55 11 36743787
E-mail: joao.santos@br.pwc.com

Tax & Legal

Alvaro Taiar
Tel: +55 11 36743833
E-mail: alvaro.taiar@br.pwc.com

Ana Luiza
Tel: +55 11 36743787
E-mail: ana.luiza@br.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Bulgaria

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Bulgaria 3

Real Estate Investments – Bulgaria 5

Contacts 13

All information used in this content, unless otherwise stated, is up to date as of 4 May 2016.

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-states and EEAA-states for a period of 7 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 5 years and for the legal entities to be registered under Bulgarian Company Law for more than 5 years.

The internal legislation has a different approach towards individuals and legal entities coming from any other country (non-EU and EEAA 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. Companies applying IFRS are obliged to capitalise interest expenses in the value of the property. The rental income realised from foreign individuals or legal entities are generally subject to 10 % withholding tax unless exempt or reduced under an applicable double tax treaty.

Thin capitalisation

Interest expenses incurred by a domestic or a foreign resident company may not be fully 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, they may be reversed during the following five consecutive years, if there are sufficient profits.

Depreciation

For tax purposes depreciation is calculated in accordance with the straight-line method only.

The tax depreciation is computed on the basis of tax depreciation plans, which have to be prepared separately from accounting depreciation plans. Corporate tax depreciation rates vary from 4% to 50%, depending on the nature of the asset. The maximum depreciation rate for buildings is 4% yearly.

Land may not be depreciated for tax purposes.

Real Estate Investments – Bulgaria

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 2 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 8.5% and 11% for the respective real estate segments.

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-states and EEAA-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-states and EEAA-states for a period of 7 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 5 years and for the legal entities - registration under Bulgarian Commercial Law for more than 5 years. As a result a legal entity

registered in EU-states and EEAA-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 5 years or (ii) if registered for less than 5 years, its shareholders have lived in Bulgaria for more than 5 years.

A natural person is entitled to acquire agricultural land if he/she has lived in Bulgaria for more than 5 years.

The internal legislation has a different approach to the individuals and legal entities coming from any other country (non-EU and EEAA 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, on the basis of 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 are exempt from corporate income tax. These legal entities are joint stock companies, which may invest only in real estate and receivables and are obliged by law to distribute not less than 90% of the realized 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 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/EEAA resident companies.

- Interest and royalty accrued to related parties established in the EU are not subject to WHT.

- 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 3.0%;
- 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 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.

Bulgarian tax law requires that transactions between related parties be carried out at an arm's length basis, i.e. at usual 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 VAT rate is currently 20%. There is a reduced rate of 9%, which applies for accommodation in hotels and other similar places.

The VAT registration is mandatory (eg, when reaching a taxable turnover of 50,000 BGN for a period of 12 months, performing intra-community acquisitions, supply/receipt of services subject to reverse charge, etc) and voluntary.

Foreign resident companies not established in another EU Member State may be registered for VAT 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 rent of land is generally VAT-exempt. However, the transfer of regulated land plots (ie, land that is eligible to be built upon) is a VAT-able supply.

The disposal of buildings 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 or units in them is always subject to VAT.

The rent of buildings is a VAT-able supply, except for when the buildings or units in them are 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, it would be entitled to partly recover the input VAT. A change of the use of the building from non-exempt 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. VAT is charged by the recipient of the above services (a taxable person) in Bulgaria under the reverse charge mechanism in case the supplier is a taxable person not established in Bulgaria.

The general period for VAT recovery is 2 months and days 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 due from the owner of the real estate in two instalments: from 1 March to 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 are subject to a 5% WHT. 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, residing in an EU/EEAA country are exempt from WHT, unless in case of hidden profit distribution.

There is no WHT on dividends payable between Bulgarian companies. Such dividends are not taxable for the receiving company. An exception is envisaged where the distributing entity is a special purpose investment company or in cases of hidden profit distribution.

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 Directive as implemented in the local legislation, income from interest payments made from local to EU entities when the payer and the recipient of the income are related parties are exempted 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-states and EEAA-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 (*akcionerno 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 is included in the corporate income tax base of the company and taxed at the regular corporate income 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 domestic company by a foreign shareholder are subject to Bulgarian WHT of 10%, unless the share transfer is executed on a regulated market in EU/EEA. The tax liability may be reduced under an applicable DTT. However, certain DTTs (eg, with the US, Ireland, Sweden, Canada, Ukraine) provide that the tax exemption does not apply if the main assets of the company are directly or indirectly holdings in real estate.

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, unless the share deal is executed on a regulated market in 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 3.0%. 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 in case the property is transferred to a company in the form of an in-kind contribution or as a result of transformation of the company (eg, 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.
- 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 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, they may be reversed during the following five consecutive years, if there are sufficient profits.

Foreign exchange differences

Foreign exchange fluctuation on receivables and payables in a currency that is different than 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.

Withholding tax

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 Directive as implemented in the local legislation, interest accrued by Bulgarian

companies to EU tax residents 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.

Contacts

Advisory

Rossitza Stoykova
Tel: +359 2 9355200
E-mail: rossitza.stoykova@bg.pwc.com

Assurance

Gueorgui Nikolov
Tel: +359 2 9355200
E-mail: gueorgui.nikolov@bg.pwc.com

Tax

Orlin Hadjiiski
Tel: +359 2 91003
E-mail: orlin.hadjiiski@bg.pwc.com

Legal

Mariana Velichkova
Tel: +359 2 9355100
E-mail: mariana.velichkova@tbk.bg

www.pwc.com/goingglobal

Real Estate Going Global Canada

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Canada 3

Contacts 8

All information used in this content, unless otherwise stated, is up to date as of 15 April 2016.

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 entities (ie, to form a partnership or corporation) are not immediately deductible. Where the entity carries on a business, 75% of these costs may be amortized for income tax purposes at the rate of 7% per annum using a declining balance method. Recent proposed legislative changes would result in certain expenditures of this nature being treated in a manner similar to depreciable property which would be eligible for CCA at a rate of 5%.

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 widely 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 an 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 widely, generally 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 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 exceeds the property's undepreciated capital cost, the excess amount (up to the capital cost of the property) is taxable to the non-resident, at the tax rate that would apply if the non-resident were a resident of Canada, as recaptured depreciation.

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

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

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

Loss 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 3% 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.

Contacts

Advisory

Lori-Ann Beausoleil
Tel: +1 416 6878617
E-mail: lori-ann.beausoleil@ca.pwc.com

Wesley Mark
Tel: +1 416 8145877
E-mail: wesley.mark@ca.pwc.com

Assurance

Frank Magliocco
Tel: +1 416 2284228
E-mail: frank.magliocco@ca.pwc.com

Daniel D'Archivio
Tel: +1 416 6878803
E-mail: daniel.darchivio@ca.pwc.com

Andrew Popert
Tel: +1 416 6878901
E-mail: andrew.popert@ca.pwc.com

Tax

Christopher J. Potter
Tel: +1 416 8692494
E-mail: chris.j.potter@ca.pwc.com

Chris Vangou
Tel: +1 416 8155015
E-mail: chris.vangou@ca.pwc.com

Ken Griffin
Tel: +1 416 8155211
E-mail: ken.griffin@ca.pwc.com

David Glicksman
Tel: +1 416 9478988
E-mail: david.glicksman@ca.pwc.com

Dean Walton
Tel: +1 416 2181512
E-mail: dean.walton@ca.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global China

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax and Investment Summary – China 3

Contacts 10

All information used in this content, unless otherwise stated, is up to date as of 16 June 2016.

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 belongs to 'Restricted Foreign Investment Industries' in China.

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.

According to the prevailing Foreign Investment Guidelines issued by the PRC government, foreign investors are restricted to be engaged in (1) large scale property development under the joint venture mode; (2) the construction and management of high-grade hotels, high-level office buildings and international meeting and exhibition centres; (3) a real estate agency.

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 4 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 5 certified full-time professionals in real estate and/or construction engineering;
- Having at least 2 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 contact.

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 income tax (WIT)

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 WIT on China sourced income. The WIT 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% WIT. For the capital gain derived from the equity transfer of the project company in China, 10% WIT will be levied. The WIT 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 11% or 5% depending on the status of the taxpayer and the property.

Land value appreciation tax (LVAT)

The land value appreciation amount is subject to LVAT with progressive tax rates from 30% to 60%. For sales of an ordinary standard property unit, LVAT can be exempted if the appreciation portion is not exceeding of 20% of the amount of deductible items.

Provisional LVAT is also imposed on proceeds of the pre-sales of properties, reviewed by a property developer at the rates ranging from 2% to 8% in generally case. A project with a higher appreciation is subject to higher provisional LVAT rate.

Real property tax (RPT)

For a real property owned by the enterprise, 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 (D)

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 5 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 5 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 10% 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 11% depending on the status of the construction enterprise and the status of the construction project.

Contacts

Advisory

Nelson IP Lou
Tel: +86 10 6533-2003
E-mail: nelson.ip.lou@cn.pwc.com

Andrew Li
Tel: +86 21 2323-3437
E-mail: andrew.li@cn.pwc.com

Victor Huang
Tel.: +852 2289-2319
E-mail: victor.wd.huang@hk.pwc.com

Assurance

Wilson Liu
Tel: +86 10 6533-2278
E-mail: w.liu@cn.pwc.com

Sally Sun
Tel: +86 21 2323-3955
E-mail: sally.sun@cn.pwc.com

Alan Ho
Tel: +852 2289-2168
E-mail: alan.ho@hk.pwc.com

Tax

Kelvin Lee
Tel.: +86 22 2318-3068
E-mail: kelvin.lee@cn.pwc.com

Rex Chan
Tel: +86 10 6533-2022
E-mail: rex.c.chan@cn.pwc.com

May Zhou
Tel: +86 21 2323-3108
E-mail: may.zhou@cn.pwc.com

KK So
Tel: +852 2289-3789
E-mail: kk.so@hk.pwc.com

Jacqueline Wong
Tel: +852 2289-3706
E-mail: jacqueline.sy.wong@hk.pwc.com

Matthew Wong
Tel: + 86 21 2323-3052
E-mail: matthew.mf.wong@cn.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Cyprus

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Investments – Cyprus 3

Contacts 10

All information used in this content, unless otherwise stated, is up to date as of 1 June 2016.

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 straight forward 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 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 his/her other Cyprus taxable income and the applicable income tax rates are as follows:

As of 1 January 2011:

Chargeable Income €	Tax rate %	Accumulated Tax €
0 to 19,500	-	-
19,501 to 28,000	20	1,700
28,001 to 36,300	25	3,775
36,301 to 60,000	30	10,885
More than 60,000	35	

Property running costs 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 the rental income are deductible if the investor is a company. Individuals are not allowed to deduct such actual costs, but instead can deduct a notional 20% on the gross rental income, independent of whether any actual expenses were incurred in deriving the rental income or not.

Interest on borrowings used to acquire the property is deductible against rental income for both individuals and company investors.

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 investor at the rate of 3% for commercial buildings, and 4% for industrial buildings. In the case that industrial and hotel buildings are acquired during the tax years 2012 and 2016 (inclusive), an accelerated tax depreciation at the rate of 7% may be claimed. These rates are amended accordingly in the case of second-hand buildings.

Upon disposal of the property, a tax balancing allowance/charge is calculated on the difference between sale 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 allowances on property from which rental income was received 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.

Having said that, subject to certain conditions, land as well as land with buildings, acquired in the period of 16 July 2015 up to 31 December 2016 will be exempt from Capital Gains Tax upon its future disposal.

Capital gains tax applies at the rate of 20% on the disposal of property. For capital gains tax purposes, property includes immovable property situated in Cyprus as well as shares of companies which directly own immovable property situated in Cyprus. As of 17 December 2015, the definition of the term is extended to include shares in companies which indirectly own Cyprus immovable property and at least fifty percent (50%) of the market value of the shares in question derive their value from the market value of the Cyprus immovable property. For shares capital gains tax only applies to that part of the gain which is attributable to the immovable property situated in Cyprus.

Shares listed on any recognised stock exchange are exempt from capital gains tax.

The gain subject to tax is the difference between the sale proceeds and the original cost of property as adjusted by an indexation allowance based on the movement of the retail price index. In the case of property acquired before 1 January 1980, the market value as of 1 January 1980 may be used as cost. In addition, sale and other expenses incurred relating to the property for which deduction was not claimed for income tax purposes can be deducted from the capital gain.

The following lifetime exemptions are available to individuals:

- €17,086, of gain arising from the disposal of any property.
- The first €25,629 of gain arising from the disposal of agricultural land by a professional farmer.
- The first €85,430 of gain arising from the disposal of a private residence under certain conditions.
- An individual claiming a combination of the above may claim up to a 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 carryforward

The income 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 corporates, group loss relief provisions 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:

- One company holding directly or indirectly at least 75% of the voting shares of the other company.
- 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 will not affect the eligibility for group relief as long as such company is tax resident 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 is imposed on the market value as at 1 January 1980 and applies to immovable property located in Cyprus owned by the taxpayer on 1 January of each year. This tax is payable on 30 September each year. A discount of 10% of the tax due is available if the tax is paid by 31 August each year. Physical and legal persons are both liable to Immovable Property Tax.

As of 1 January 2013, the bands and rates for Immovable Property Tax for properties situated in Cyprus are per the table below which apply per owner, not per property:

Property Value as at 1 January 1980 €	Tax rate %	Accumulated Tax €
Up to 40,000*	6	240
40,001 to 120,000	8	880
120,001 to 170,000	9	1,330
170,001 to 300,000	11	2,760
300,001 to 500,000	13	5,360
500,001 to 800,000	15	9,860
800,001 to 3,000,000	17	47,260
More than 3,000,000	19	

*Property owners whose property has a total value of €12,500 or less (using values of 1 January 1980) are exempt from Immovable Property Tax.

Transfer fees and mortgage fees

The fees charged by the Department of Land and Surveys to the acquirer for transfers of immovable property are as follows:

Market Value €	Rate %	Fee €	Accumulated Fee €
First 85,000	3	2,550	2,550
From 85,001 to 170,000	5	4,250	6,800
More than 170,000	8		

Subject to certain conditions (a) the purchaser is not liable to pay transfer fees if the transaction is subject to VAT or (b) if the transfer fees are reduced by 50% for non-VATable transaction, where (i) the transfer takes place by 31 December 2016 irrespective of the date of the signing of the contract or its submission to the Land Registry Office or (ii) where the contract was signed and submitted to the Land Registry between the period 2 December 2011 and 31 December 2016 irrespective of the transfer date.

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

Unless otherwise stipulated in the sale-purchase contract, the purchaser is liable for the payment of stamp duty at the rate of 0.15% on the contract price for amounts between €5,001-€170,000 and 0.2% thereafter, with a maximum total stamp duty of €20,000.

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 at an effective rate of 2.25% earned by Cyprus tax resident companies and Cyprus tax resident-domiciled individuals.

As of 1 July 2011, companies, partnerships, the Government or any local authorities that pay rent are required to withhold the SDC due at source.

The SDC withheld is paid by the tenant to the Tax Department by the end of the month, following the month in which tax was withheld.

Value-added tax (VAT)

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

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 10 years.

The reduced rate of 5% applies for the first 200 square metres of residences of total covered area of up to 275 square metres. In the case of families with more than 3 children the allowable total covered area increases by 15 square metres per additional child beyond the three children.

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 10 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.

Persons who make a false statement 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 3 years or may be subject to both sentences.

Contacts

Advisory

Constantinos Constantinou
Tel: +357 22 555700
E-mail: constantinos.constantinou@cy.pwc.com

Assurance

Liakos M Theodorou
Tel: +357 22 555160
E-mail: liakos.m.theodorou@cy.pwc.com

Tax

Stelios A Violaris
Tel: +357 22 555300
E-mail: stelios.violaris@cy.pwc.com

Indirect Tax

Chrysilios Pelekanos
Tel: +357 22 555280
E-mail: chrysilios.pelekanos@cy.pwc.com

Legal

Spyros Evangelou
Tel: +357 22 555900
E-mail: spyros.evangelou@cy.pwclegal.com

www.pwc.com/goingglobal

Real Estate Going Global Czech Republic

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Czech Republic 3

Real Estate Investments – Czech Republic 5

Contacts 13

All information used in this content, unless otherwise stated, is up to date as of 18 May 2016.

Real Estate Tax Summary – Czech Republic

Introduction

The real estate sector in the Czech Republic has experienced significant growth in 2015 and early 2016. 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 2016 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.
- 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 generally 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.

Legal aspects

Due to foreign exchange restrictions, foreign companies that wished to acquire Czech real estate have, in the past, established or acquired Czech companies. This restriction was based on special conditions agreed between the Czech Republic and the EU, ie, a seven-year transition period applies since the Czech Republic joined the EU in 2004.

Ownership of real estate can be acquired through, eg, a purchase contract or donation, a contribution to a company, or inheritance.

A contract for the transfer of real estate must be in writing and the signatures must be verified. If real estate is transferred on the basis of a contract, ownership is acquired by its registration with the Real Estate Cadastre, according to specific regulations governing such a transfer (unless a special law provides otherwise).

Review of ownership titles is an important component of legal due diligence in the Czech Republic, because of the transformation of real estate evidence in the Czech Republic in the early 1990s and the previous regime, during which ownership rights were not properly entered into books.

Real Estate Investments - Czech Republic

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*).
- 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 (€ 80k).

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; real estate transfer 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 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

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.

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.

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.

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 (eg, between the Czech Republic and France), such an exemption does not apply if the assets of the entity of which the shares are sold consist only or predominantly of immovable property.

Capital losses from the alienation of shares in a limited liability company are not tax-deductible. The same treatment applies in general to joint stock companies, although certain exceptions may apply.

Use of separate property holding companies

To avoid taxes on the disposal of the property, it is common practice to hold properties in separate special-purpose companies. Disposals are 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

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%. 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. The vendor is liable to pay the REAT if both parties, vendor and buyer, have not agreed upon the purchase agreement that a buyer is liable to pay REAT of 4%. If vendor is liable to pay REAT, the buyer of the real estate guarantees the payment by the vendor by operation of law.

Please note that the Chamber of Deputies is currently looking at an amendment according to which REAT should be paid by the acquirer only. The amendment only passed the second reading in the Chamber of Deputies, so the day of its entry into legal effect is yet unclear.

REAT paid to the Czech tax authorities is considered as a tax-deductible cost for CIT purposes.

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.

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 in the Czech Republic

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 withholding tax 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.

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

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.

Equity financing

Increase of registered share capital

According to the Czech Commercial Code, certain formal procedures must be undertaken to increase the registered share capital of a Czech company. These are not further commented on in this publication.

Contribution into other capital funds

Czech legislation expressly states the possibility of making monetary contributions to the equity of a limited liability company that do not form part of the registered share capital. This non-registered equity is referred to as 'other capital funds'. A contribution to the other capital funds account is administratively relatively easy, as it does not have to be registered with the Czech Commercial Register.

A contribution to other capital funds has no influence on the amount of the registered share capital. It should be also possible to repay contributions to shareholders, but only as far as losses have been covered.

A similar possibility to create other capital funds can exist in certain circumstances for joint stock companies having a single shareholder.

Municipal tax system in the Czech Republic

General

Real estate tax consists 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 4.5. 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.

Contacts

Advisory
Jan Dvorak
Tel: +420 251 151201
E-mail: jan.dvorak@cz.pwc.com

Assurance
Richard Jones
Tel: +420 251 152161
E-mail: richard.b.jones@cz.pwc.com

Tax
Matej Cano
Tel: +420 251 152666
E-mail: matej.cano@cz.pwc.com

Legal
Michael Mullen
Tel: +420 737 210694
E-mail: michael.mullen@cz.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Denmark

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Denmark 3

Contacts 7

All information used in this content, unless otherwise stated, is up to date as of 26 April 2016.

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 4.3% (2016 figure) 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.

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 4.3% 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% (proposed reduced to 22%). Dividends would not be subject to Danish WHT, provided the recipient 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 2017. Denmark has also introduced both treaty and directive anti-avoidance rules in 2015, but there is not yet any case law so the application is still uncertain. 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).

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 carryforward

Any operating losses may be carried forward and offset positive income of the company itself or income of entities that were members of the joint taxation during the period the losses derive from. Change of ownership may restrict the possibility to carry forward losses.

New rules have been adopted whereby losses carry forward may not reduce the taxable income by more than 60%. A safe harbour of 7.9m DKK 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.

Contacts

Advisory

Per Andersen
Tel: +45 39453411
E-mail: PER@pwc.dk

Peter Gill
Tel: +45 39453417
E-mail: PGL@pwc.dk

Ragna Ceder
Tel: +45 39459280
E-mail: RAC@pwc.dk

Assurance

Jesper Wiinholt
Tel: +45 39453311
E-mail: JEW@pwc.dk

Tax & Legal

Daniel Noe Harboe
Tel: +45 39459582
E-mail: DNH@pwc.dk

Mick Jørgensen
Tel: +45 39459423
E-mail: MIK@pwc.dk

www.pwc.com/goingglobal

Real Estate Going Global Finland

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Finland 3

Real Estate Investments – Finland 4

Contacts 8

All information used in this content, unless otherwise stated, is up to date as of 19 April 2016.

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 *Kommandiittiyhtiö* (Ky), or a non-resident company or partnership. 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 2016). 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 accrue to the shareholder of the MREC, whereas in case of a regular real estate company, rental income will accrue to the real estate company.

Interest limitation rules

Finland applies interest limitation rules as of tax year 2014 and onwards. Deductibility of interest expenses for intra group loans is generally restricted to 25% of fiscal EBITDA. However, the limitations do not apply to interest income regarded as personal income (non-business income), which means that the limitations do not normally apply to housing companies and companies engaged in certain types of real estate renting.

Debt-to-equity ratio must in all cases be at arm's length and is to be considered on a case-by-case basis.

Depreciation

Tax depreciation is limited to the cumulative charges made in the books. Acquisition costs of land may not be depreciated. Acquisition costs of buildings and other constructions are depreciated using the declining balance method, the maximum rates being, eg, 4% for residential buildings, office buildings or other similar buildings, 7% for shops, warehouses, factories, workshops, power stations or similar buildings; 20% for buildings or constructions or part of 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 those who own the taxable property at the beginning of the calendar year, even if they are non-resident investors.

The tax rate is based on the taxable value of each individual real estate property. The general tax rate may vary between 0.80% and 1.55% (year 2016). For permanent residences, the tax rate may vary between 0.37% and 0.80% (year 2016). 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 1% and 4% (year 2016).

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 this respect.

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 group consolidation to offset the losses and gains in a group of companies. However, real estate companies are generally **not entitled to the group contributions' system.**

Capital gains

Capital gains realised on the sale of Finnish real estate property is taxable income for a Finnish resident vendor. Similarly, capital gains 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, Finland is entitled to tax the capital gain realised by a non-Finnish resident, eg, on a transfer of Finnish real property or shares in a Finnish residential housing company or other company, of which more than 50% of the assets comprise real estate property. An applicable tax treaty may have an effect on the on the Finnish taxation of capital gains.

Loss carry forward

In principle, ordinary tax losses from business activities can be carried forward for ten years. Carryforward of tax losses is 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 accounting 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. Also transfer of shares in a foreign holding company owning shares in a Finnish real estate company may be subject to 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.

Value-added tax (VAT)

The general Finnish VAT rate is 24% (year 2016). 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.

VAT relating to transaction costs is only deductible, if the purchaser is registered for VAT and the transaction relates to the company's VAT-able 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

The rules related to real estate investments changed as of 1 January 2008 applying to construction and refurbishment finished on 1 January 2008 or later. 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

A domestic reverse charge system in the construction sector came into force on 1 April 2011. The aim of the 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 eg, construction services such as excavation and foundation work, construction work, installation work, finishing work, on-site cleaning and supplying contracted employees to a site. It is noteworthy that the scope of services to which the reverse mechanism applies is still relatively unclear so it is advisable to check each service separately before invoicing it.

In situations where the reverse charge applies and the buyer is VAT liable, the seller is required to issue an invoice. It is the seller's obligation to establish whether the buyer meets the requirements for the reverse charge system outlined above. If both the services in question and the status of the purchaser meet the requirements, it is mandatory to invoice the services without VAT using the reverse charge mechanism. The supplies and purchases as well as the Finnish VAT calculated by the buyer are reported separately in the Periodic Tax Return form.

Contacts

Advisory

Jeroen Bus
Tel: +358 20 7877886
E-mail: jeroen.bus@fi.pwc.com

Thomas Blumberg
Tel: + 358 20 7877732
E-mail: thomas.blumberg@fi.pwc.com

Assurance

Juha Tuomala
Tel: + 358 20 7877451
E-mail: juha.tuomala@fi.pwc.com

Juha Wahlroos
Tel: +358 20 7877437
E-mail: juha.wahlroos@fi.pwc.com

Tax

Karin Svennas
Tel: +358 20 7877801
E-mail: karin.svennas@fi.pwc.com

Tuula Pirinen
Tel: +358 20 7878271
E-mail: tuula.pirinen@fi.pwc.com

Eija Kuivisto
Tel: +358 20 7877876
E-mail: eija.kuivisto@fi.pwc.com

Juha Laitinen *(VAT)*
Tel: +358 20 7877409
E-mail: juha.laitinen@fi.pwc.com

Samuli Makkonen *(Financial Services)*
Tel: +358 20 7877752
E-mail: samuli.makkonen@fi.pwc.com

Legal

Mikko Reinikainen
Tel: + 358 20 7877463
E-mail: mikko.reinikainen@fi.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global France

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – France 3

Real Estate Investments – France 9

Contacts 53

All information used in this content, unless otherwise stated, is up to date as of 26 April 2016.

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 simplifée* (SAS), or non-resident company, or through a partnership such as a *société civile immobilière* (SCI).

Foreign investors frequently invest in French real estate assets through a two-tier structure, in which a French company owns the real estate asset, with the shares of the French entity being held by a foreign holding company (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

Net rental income is taxable in France at a rate of 33.33%.

The effective rate of corporate income tax is:

- 34.43% (surcharge of 3.3%) should taxable income exceed €2.289m;
- 36,9% (surcharge of 10.7%) should taxpayer's turnover exceed €250m (this surcharge of 10.7% is applicable until financial years closed as of 31 December 2016);
- 38% if the two above mentioned criterion are fulfilled.

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 85% of the interest for financial years closed as of 31 December 2012, and 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 nonresident 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 9.5%). 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 (eg, 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 (2.15% for FY2015) 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 (eg, 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; 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).

Depreciation

Each component of a property must be booked individually and depreciated accordingly, ie, facade, heating system, structures, interiors, etc.

For properties held by a look-through entity (such as an SCI or a *société en nom collectif*, SNC), the deductible depreciation charge can be limited by the amount of the net rental income generated by the property (difference between the rents and all the property-related costs, including interest), the excess being carried forward indefinitely.

It should also be noted that under certain circumstances, buildings are not treated as depreciable assets, but as inventory (eg, when owned by brokers or developers).

Capital gains on the sale of property

Subject to tax treaties, capital gains realised upon the sale of French properties and the sale of real estate shares by local and foreign companies are taxed at 33.33% (34.43%, 36.9% or 38% including surtaxes payable by French tax residents only), which is the standard corporate income tax rate.

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% WHT 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.

Additional corporate income tax (CIT) on dividends

Section 6 of the Second Amendatory Finance Bill for 2012 introduced an additional CIT of 3% applicable to dividend payments, or to deemed distribution realized as from 17 August 2012, by French or foreign companies and organisms liable to CIT in France and especially to distributions made by SIIC to their shareholders and to distributions from SPPICAV subsidiaries to their parent entities.

Some distributions are specifically excluded from the scope of the 3% tax:

- Amounts distributed between companies which are members of the same tax consolidated group
- Distributions of dividends paid in shares (under some conditions)
- Distributions of dividends from SIIC subsidiaries to SIIC parent company and distributions to be paid by SIIC in 2013 to meet the distribution requirements.

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 (eg, sovereign states, entities where stocks are admitted to negotiation on a regulated market and are regularly and

significantly traded, pension funds, non-listed open-ended real estate funds) and exemptions subject to filing requirements may apply.

Withholding tax/dividends

Subject to tax treaty provisions, a 30% WHT 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.

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 5.80% (or 5.09% in certain 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 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 realized.

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 *('bail à construction'*)

A construction lease 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 *('bail emphythéotique'*)

These 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.

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 (*'promesse unilatérale de vente'*)

In the unilateral commitment of sale, 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.

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 (*'promesse synallagmatique de vente/contrat de vente'*)

In the agreement of sale, 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.

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* **'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. They are approximately 0.825% plus VAT, calculated on the purchase price. 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 resale/erect/rebuild the building). The following cases illustrate the principles herein above-mentioned:

- The disposal of building land ('*terrains à bâtir*') by a VAT-able company, the vendor will be subject to VAT. If the buyer intends to erect a building on the land, she/he would be subject to a €125 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 0.715% 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 0.715% 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, 5.8% (or 5.09% 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.

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.

Permanent establishment in France

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.

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 tax is 33.33%.

The standard rate of 33.33% is increased by a 3.3% corporate tax surcharge that applies for companies with taxable income **exceeding €2.**289m. This surcharge results in an effective overall taxation rate of 34.43%.

The standard rate of 33.33% is increased by a 10.7% corporate tax surcharge that applies for companies **with a turnover exceeding €**250m (excluding VAT). This surtax, which results in an effective overall taxation rate of 36.9%, is applicable until the 30th December 2016.

For companies wi**th taxable income exceeding €2.289m** and a turnover exceeding €250m (excluding VAT), the effective overall taxation rate is 38%.

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 30% reduced to 21% for individuals located in the EU, Iceland and Norway).

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%.

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 *scenarii*, 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.

- 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.
- 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.
- A discretionary consent is required to convert residential premises to offices or any other use.

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 deductible against corporate tax, ie, a maximum 38% 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 €400 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 0.715% levied on the total rents (minus that part of the rent that corresponds to the financing costs) payable over the entire duration of the lease (subject to a cap of 20 years if the lease exceeds that duration).

Rental tax or VAT on rents

Rents are either subject to VAT at the standard rate of 20%) if the rented premises are professional furnished ones or if the lessor has elected for VAT. Otherwise, rents are liable to a rental tax equivalent to 2.5% of the annual rent if the building is over 15 years old.

Tax deductibility of the rents paid by the lessee

In principle, rents are tax-deductible, except for the portion that corresponds in fact to non-depreciable assets (ie, essentially the land), with several specific rules for office premises located in the Paris area and completed after 31 December 1995.
The financing company itself communicates the amount of the rent that is deductible to the tenant.

Purchase of the building at the end of the lease

The purchase of the building by the tenant at the end of the finance lease gives rise to registration duty at an effective rate of 5.8% (or 5.09% 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 (eg, in order to purchase assets) are tax-deductible, providing that the T&C of the loan are on an arm's length basis.

In addition, 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 85% of the interest for financial years closed as of 31 December 2012, and 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 9.5%). 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 (eg, 2.15% for FY 2015)

- 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

Remuneration of shareholders

Limited liability companies

After-tax profits distributed to its shareholders by a French limited liability company qualify as dividends. When distributed to non-resident shareholders, dividends are, in principle, subject to WHT, deducted at source, at a rate of 30% for the entities, 21% for the individuals resident in the EU, Iceland and Norway, and 75% if paid in a non-cooperative State or territory.

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
- 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
- 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 f**or 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.

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.

Wealth tax (*Impôt de Solidarité sur la Fortune* (ISF))

Under French domestic law, a non-resident individual, owning directly or indirectly, a French real estate property is liable to French wealth tax if the global net value of all his/her French assets exceeds €1.3m as of 1 January; the rates are those of a progressive bracket scale, which range from 0% to 1.5%.

The indirect ownership test is met either when (i) an individual owns shares in a company, French or not, whose assets mainly consist, directly or indirectly, of French real estate properties or, (ii) in the case where the interposed company's assets do not consist mainly of French real estate properties, if said individual, together with his/her spouse, parents, children, sisters and brothers, holds, directly or indirectly (and whatever the number of interposed legal entities or organisations) 50% of the capital of a legal entity or organisation owning a French real estate property.

The application of these provisions will, of course, depend on the terms of the applicable tax treaty, if any, from which said individual may seek the protection.

In this respect, it must be noticed that not all tax treaties deal with wealth tax issues, and in such a case, French domestic tax provisions will apply unilaterally.

The ISF will be levied either on the value of the property if it is held directly, or otherwise up to the value of the shares held directly by the taxpayer and deriving from the French property.

Business licence tax (*Contribution Economique Territoriale*)

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.

- 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).

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% WHT) 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% WHT (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 WHT 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 34.5% (19+15.5), 48.8% (33.33+15.5), or 90.5% (75+15.5);

- 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 hold for more than 22 years or residence in France of a non-resident.

Sale by a French limited liability company

Sale of the real estate

The taxable capital gain, usually equal to the difference between the sale price of the building and its net book value, is taxed at the standard 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-REIT or *sociétés d'investissements immobiliers cotées* (SIIC)

Main tax rules

A specific tax regime is offered to listed real estate companies (*sociétés d'investissements immobiliers cotées*).

By virtue of said provisions, companies, whose main activity is the leasing of properties as well as the subletting of properties under certain circumstances, which have a share capital at least equal to €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 2011, there were around 40 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 'OPCI' (*'Organisme de Placement Collectif en Immobilier'*).

The OPCI regime is available through two alternative vehicles, which are the *'Fonds de Placement Immobilier* (FPI)', having no legal personality (tax transparency) and the *'Société de Placement à Prépondérance immobilière à capital variable* (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 15.5% 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 15.5% 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 15.5% of social contributions.

- Non-residents are subject to WHTs on dividends (30% for the entities and 21% 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 tax system in France

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
- Habitation tax

Business tax overview (BT)

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.

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 immoveable assets.

The real estate rental value is to be modified on 1 January of each year following an addition/removal of building. Then, any square metre increase/decrease induces an increase/decrease of the real estate rental value for commercial buildings, and any addition/removal of assets should normally be declared to the tax authorities (by the lesser or even the lessee).

Tax rates are levied for the benefit of the regions, departments and municipalities (ie, public entities that have administrative and taxing powers), so the global property tax rates are then very different from one site to another.

Miscellaneous taxes

Other miscellaneous taxes linked to real estate are levied for the benefit of local governments, such as the following:

- Registration duties on transfer of real estates
- Duties for use of public streets/places
- Mining fees
- Accommodation fees
- 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 additional CIT on dividends.
- 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.

Contacts

Tax

Bruno Lunghi
Tel: +33 1 56578279
E-mail: bruno.lunghi@pwcavocats.com

Philippe Emiel
Tel: +33 1 56574166
E-mail: philippe.emiel@pwcavocats.com

www.pwc.com/goingglobal

Real Estate Going Global Germany

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Germany 3

Real Estate Investments – Germany 6

Contacts 47

All information used in this content, unless otherwise stated, is up to date as of 11 May 2016.

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 7.0% and 17.85%, 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 is imposed on the consideration paid for the transfer of real estate. 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 and Thuringia. 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 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.

Transfer tax is also imposed on certain transactions that are deemed to constitute a transfer of property ownership, ie, where 95% or more of the shares in a company that owns German real estate are transferred or assembled in the hands of one shareholder, and on changes in the ownership of a partnership, where 95% or more of the partnership capital is transferred within a five-year period. However, certain cases of intra-group reorganisations are exempt from real estate transfer tax.

In a recent amendment of German RETT law 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 will apply on all transactions from 7 June 2013 on, as the bill has been passed by the German Federal Parliament on 6 June 2013.

VAT

The VAT rules which apply in the case of the transfer of real estate are complicated and require particular attention. If the item of real estate constitutes the complete business of the seller, or an independent part thereof, the sale is not subject to VAT. Otherwise, the transfer constitutes a taxable event for VAT purposes, but exemption from tax is specifically granted where the transaction is subject to real estate transfer tax. The seller nevertheless has an option in this case to voluntarily subject the transaction to VAT if the real property is sold to an entrepreneur who intends to use the real estate for the purpose of generating VAT-taxable turnover. The exercise of this option may be attractive for the seller, where this permits the latter to avoid having to repay to the tax **administration, input VAT amounts billed to him in suppliers' invoices on the erection** of the building, which otherwise would have to have been repaid to the tax administration on a change in usage of the property for VAT purposes (from taxable letting to a tax-exempt sale).

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)'*, ie, 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*, 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 value-added tax (VAT) and the real estate transfer tax (*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, ie, 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*, GmbH), or public incorporated company (*Aktiengesellschaft*, 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*, OHG), limited partnership (*Kommanditgesellschaft*, KG), or civil law partnership (*Gesellschaft bürgerlichen Rechts*, 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 barrier 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 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).

- 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.

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.

In the case where a loss carrying corporation is merged into another corporation, all loss carryforwards are forfeited.

The new 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 withholding tax (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;
- 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 €8,652.

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 withholding tax 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 = 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 withholding tax 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 permanent establishment (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 7.0% to 17.85%, 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

- 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 (for details see section below 'below '*Acquisition of a German property company' – 'Tax aspects' – 'RETT'*).

In a recent amendment of German RETT law 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 will apply on all transactions from 7 June 2013 on as the bill has been passed by the German Federal Parliament on 6 June 2013.

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 also 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 Sec. 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. This procedure should be observed in the near future.

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 and Thuringia. 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 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 capitalized 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.

Value-added tax

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 immoveable property (eg, hereditary building right). Land and **buildings are viewed as 'goods' for German VAT purposes.** However, a tax exemption exists for all transactions subject to 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. (For details see section below *'Direct Investments in German property' – 'Direct purchase of assets' – '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 *'Renting' –' 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 and the owner's individual income tax position are irrelevant for the computation of the land tax. The tax base is the unitary value of the property (*Einheitswert*). The unitary value is an estimated fair market value determined 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). Generally the unitary value of real estate is only about 30% of the current fair market value.

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 annual land tax burden presently varies between 0.1% and 0.6% of the fair market value (not the unitary value). 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.

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.

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.

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*').

Real estate transfer tax

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).

Withholding tax of 25% (plus 5.5% solidarity surcharge = 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 explanation 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 permanent establishment 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 = 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.

Following most of German DTTs, capital gains derived by a non-resident corporation on the disposal of shares in a German corporation is exempt from taxation in Germany, irrespective of the percentage of shareholding. However, the OECD Model Treaty 2010 changed the allocation of right to tax. Gains derived by a non-resident from the disposal of shares deriving more than 50% of their value directly or indirectly from immoveable property situated in the other contracting state may be taxed in that other State. In recent DTTs of Germany (eg, with the UK) this rule is assumed. Even if new Double Tax Treaties provide a right for taxation in Germany, if a gain was derived from a sale of a property holding company, this should presently have no tax impact in Germany. This is due to the fact that the German income tax law does not - up to now - provide a tax clause for the sale of companies which have neither their seat nor their place of effective management in Germany.

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 (sec. 50d subsect. 3 ITA) 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 withholding tax 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.

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 withholding tax 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.

Real estate transfer tax (RETT)

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 (RETT). However, RETT will be levied where, as a result of the transfer:

- 95% or more of the shares in a real property-owning partnership are 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 section above '*Introduction*'-'*RETT*').

The applicable tax rates range from 3.5% to 6.5% and are levied on a separate real property value (see section above '***Introduction***'-'***RETT***'). 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.

Value-added tax

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 '*Direct purchase of assets*' – '*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,* 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 purchase of assets*’ – ‘*Income tax*’.)

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.

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, 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.

Value-added tax

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 individual investors to participate in partnerships consisting of a large number of participants. 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 (*Kapitalgesetzbuch)* 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 in the past.

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).

Based on the new regulation system the closed-end fund is managed by a capital management company (KVG). The KVG is not subject to the Banking Act (*Kreditwesengesetz*, KWG), but must obtain a business licence from the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, 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 MiFID (Markets in Financial Instruments Directive).

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 to be observed.
- 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 veränderlichem 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.

German Retail AIF

The open-end fund is also managed by a capital management company (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 Capital Investment Code (KAGB). The investment fund tax regime is only applicable to funds that comply with the regulations of the KAGB. Taxation of the fund and the investors in the fund is governed by the Investment Tax Act (InvTA).

Open-end funds may invest in a limited number of assets (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 immoveable 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-end funds are subject to the special tax regime of the German Investment Tax Act (InvTA). Although a fund, as a pool of assets, is technically subject to corporate income tax, the investment fund is exempt from corporate income tax and trade tax. The net income is in general directly attributed to the investors, regardless of whether it is retained or distributed. However, all income derived by German residents is not qualified as rental income but as capital income.

The InvTA provides for a tax transparency of the fund, which means that beside of the tax exemption of the fund itself the tax treatment of the investors corresponds to the tax treatment of a direct investment in the funds' assets. Due to the AIFMD implementation the InvTA was amended as well. While, the scope of KAGB became broader, only certain foreign and domestic investment funds that fulfil the respective investment fund requirements (eg, financial supervision, redemption rights, only passive investment management, only certain eligible assets, in a risk diversified portfolio, further quantitative investment limitations such as leverage, diversification etc) fall under the treatment as semi-tax transparent funds. Other funds that could not fulfil these preconditions will be either taxed as tax transparent investment partnership or as an investment corporation depending on a prior entity type classification in accordance with general German taxation principles. For InvTA purposes investment funds are divided in (i) retail investment funds and (ii) special investment funds the, latter being only open for up to one hundred investors, who are not individuals.

Rental income and capital gains from the sale of real estate are in general, fully taxable on the investor level. However, in the case of foreign real estate, such income is tax-exempt in Germany, if Germany has waived its right to tax the respective income according to the relevant DTT.

At the level of the German investors, the investment income will be taxed as follows:

- Income from dividends and income from the sale of shares is tax-exempt for corporate income tax purposes in the hands of corporate investors since these investors may benefit from the participation exemption, in case of dividends and if the holding percentage is not considered a portfolio investment neither for the special investment fund nor the investor by a look through approach. However, 5% of this income is considered as non-deductible business expenses at the investor level and, accordingly, only 95% of the dividend income is treated as non-assessable. The income may be fully subject to trade tax. The possible dividend participation exemption is not available for retail investment funds, which are open to individual investors.

- Individual investors holding the investment units in their private assets are subject to a definitive WHT of 25% on distributions and deemed distributions from a German open-end fund. This WHT is generally charged to all distributions with the exception of distributions of treaty exempt foreign income, ie, rental income from foreign properties.

- In case of an individual investor holding the fund units as business assets, 40% of this income derived from dividends or capital gains from share sales are tax-

exempt. The remaining part is subject to the personal income tax rate. The income may be fully subject to trade tax, which can be credited against personal income tax.

- Withholding tax levied on income from the fund is creditable for German investors and can be refunded to non-resident investors. Since 2009, the definitive WHT regime applies.

According to a new bill, which is currently in legislation process as of 2018 a reformed Investment Tax Act shall become effective providing for a transparent taxation regime for special investment funds and an in-transparent tax regime for retail investment funds.

Special AIFs

Special AIFs are a sub-form of real estate investment funds and do not differ substantially from 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 in 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. Although still not a common instrument, special funds offer the chance to achieve tax advantages without the full regulatory system of German retail AIFs. Moreover, if the KVG of a special AIF does not fulfil the information and publication requirements normally necessary to qualify for taxation as a transparent fund, no lump-sum taxation will arise.

In case of special AIFs German-source real estate income is classified as domestic income. There will be a tax assessment for the underlying German-source real estate income.

German Real Estate Investment Trusts (G-REITs)

The 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 *(Aktiengesellschaft).* 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,* 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 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.

Fifty per cent of capital gains realised on the disposal of real estate 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% = 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 a 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 Capital Investment Code 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 *(Gesellschaft mit beschränkter Haftung)* is advantageous and the most common form of entity, rather than the less flexible form of corporate entity – an AG *(Aktiengesellschaft)* – 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,* 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 (*Genussrechte*)

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 (eg, 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, eg, 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 (*partiarische Darlehen*)

Investments in real estate located in Germany can also be achieved by lending capital on the basis of a profit participating loan arrangement. 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.

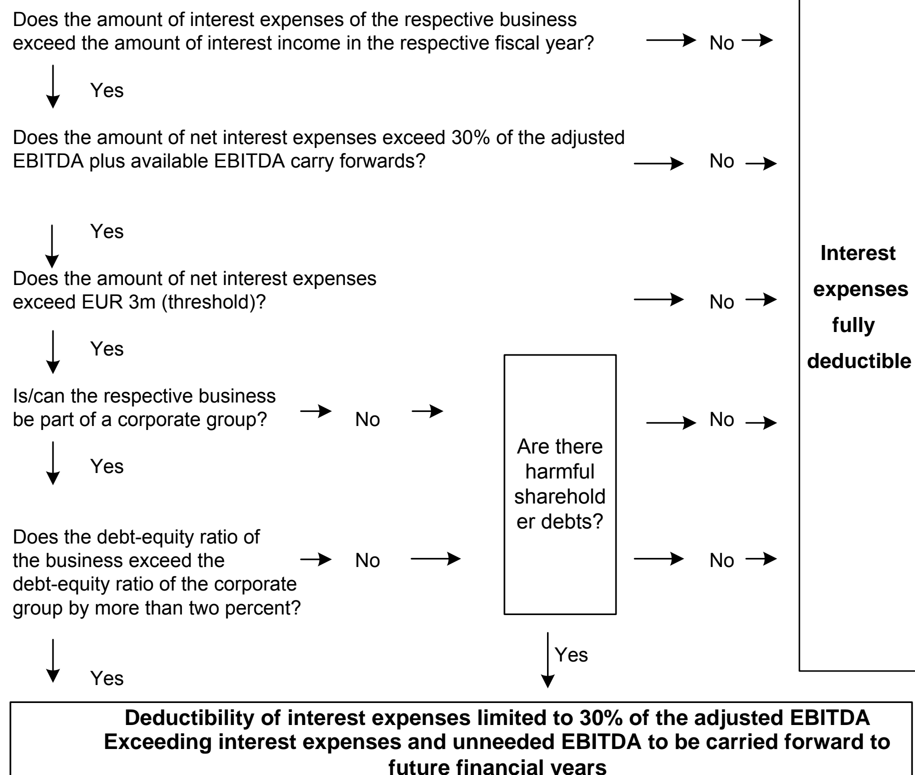
- Net interest expense is less than €3m annually.

- 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.



Withholding tax on interest

Withholding tax 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). It will therefore, 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, ie, 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 purchase of assets*' – '*Income tax*'), maintenance and financing costs, etc can be deducted in the amount actually incurred.

Value-added tax

As a general rule, the letting of immoveable 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 purchase of assets*' – '*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-lessor, without being considered the legal owner of the property.

Real estate transfer tax

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.

Value-added tax

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 immoveable 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

deductible, provided the interest barrier rules do not apply (see section above '*Tax aspects of interest payments*' –' *Interest barrier rules*').

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.

Value-added tax

If the lessor is the economic owner of the real estate for VAT purposes, the lease is treated as renting (see section above '*Renting*' – '*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 '*Tax Aspects*').

The lessor must record the minimum lease payments in their balance sheet as a receivable.

The annual lease payments are broken down into a capital and an interest component. Whereas the capital component reduces the receivable, the interest component is taxable income.

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 (15% plus 5.5% solidarity surcharge thereon, ie, 15.825%) unless the applicable tax treaty provides for an exemption.

Real estate transfer tax (RETT)

The economic ownership concept for income tax purposes is not applicable for real estate transfer tax (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 '*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 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.

Real estate transfer tax and value-added tax

The same rules apply as outlined in the section '*Direct purchase of assets*'.

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.

Contacts

Advisory

Susanne Eickermann-Riepe
Tel: +49 69 9585-5909
E-mail: susanne.eickermann-riepe@de.pwc.com

Dirk Hennig
Tel.: +49 30 2636-1166
E-mail: dirk.hennig@de.pwc.com

Thomas Veith
Tel.: +49 69 9585-5905
E-mail: thomas.veith@de.pwc.com

Assurance

Eva Handrick
Tel.: +49 69 9585-2217
E-mail: eva.handrick@de.pwc.com

Gregory Hartman
Tel: +49 30 2636-4214
E-mail: gregory.hartman@de.pwc.com

Tax & Legal

Uwe Stoschek
Tel: +49 30 2636-5286
E-mail: uwe.stoschek@de.pwc.com

Dr. Michael A. Müller
Tel: +49 30 2636-5572
E-mail: mueller.michael@de.pwc.com

Helge Dammann
Tel.: +49 30 2636-5222
E-mail: helge.dammann@de.pwc.com

Sven Behrends
Tel: +49 89 5790-5887
E-mail: sven.behrends@de.pwc.com

Marcel Mies
Tel.: +49 211 981-2249
E-mail: marcel.mies@de.pwc.com

Josip Oreskovic-Rips
Tel.: +49 69 9585-6255
E-mail: josip.oreskovic-rips@de.pwc.com

Legal

Bettina Knipfer
Tel: +49 211 981-2966
E-mail: bettina.knipfer@de.pwc.com

Real Estate Going Global
Greece

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Greece 3

Real Estate Investments – Greece 6

Contacts 16

All information used in this content, unless otherwise stated, is up to date as of 27 April 2016.

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 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 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 hopes 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 tax is based on the following tax scale[1] (for income earned as of 1 January 2014):

- at 11% for amounts up to €12,000
- at 33% for amounts exceeding €12,000

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 April of the year following the respective tax year.

The corporate income tax rate is 29% for income earned during 2015 onwards.

[1] Based on a draft bill submitted to the Greek parliament, an increase of said rates to 15% (for amounts up to €12,000), 35% (for amounts from €12,001 up to €35,000) and 45% (for amounts exceeding €35,000) is proposed.

For individual beneficiaries, the overall net income of tax years 2015 and 2016 is subject to an extraordinary special solidarity contribution imposed at the following rates[2]:

- from €12.001 to €20,000: tax rate of 0.7%
- from €20,001 to €30,000: tax rate of 1.4%
- from €30,001 to €50,000: tax rate of 2%
- from €50,001 to €100,000: tax rate of 4%
- from €100,001 to €500,000: tax rate of 6%
- exceeding €500,000: tax rate of 8%

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 sqm to aascendants 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 recognized 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. A transitional period has been introduced up to 31 December 2016 (ie, 40% for the fiscal year starting 1 January 2016).

The interest expenses are recognized as fully deductible business expenses if the amount of the booked net interest expenses does not exceed the amount of €3,000,000 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).

---

[2] Based on draft bill submitted to the Greek Parliament, the rates of the special solidarity contribution shall be increased (eg, the higher rank of income exceeding €220,000 shall be subject to a special solidarity contribution of 10%).

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%.

Real Estate Investments – Greece

Tax Aspects

Value-added tax (VAT)

From 1 January 2006, the supply before first occupation of real estate is subject to VAT at the standard rate of 23%[3]. 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 is 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.

It should be noted that the acquisition of a first residence by individuals is exempt from the VAT.

Real estate transfer tax

Any transfer of real estate which is not subject to VAT is subject to Real Estate Transfer Tax. The Real Estate Transfer Tax (RETT) rate applicable 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 real estate transfer tax is reduced to ¼ in the following cases:

- Distribution of real estate property parts among co-owners
- Dissolution of partnerships and limited liability companies (Ltds)

The real estate transfer tax is reduced to ½ in the following cases:

- Compulsory trade-off of neighbouring properties

---

[3] Based on a draft bill submitted to the Greek Parliament, an increase of the VAT rate to 24% is proposed.

- 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
- 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 (**AFM**);
- 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 recognized authority of the respective state. Non-cooperative states, as determined in article 51 A of the Greek Income Tax Code, are non EU Member States that have not concluded agreements of administrative assistance in the tax sector with Greece or with twelve other states at least and are enumerated in an annual Ministerial Decision;
- 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 whose real estate related income is less than 50% of the total turnover corresponding to their business in Greece. 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 organizations 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 Non-cooperative states;
- 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 corporate income tax 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. To be noted that 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 2016.

- 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 realized 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 permanent establishment 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 (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 (eg, location, use, flour 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 €9 per square metre and other coefficients affecting the value of the property (eg, location, use of the property, etc). Individuals owning real estate property are also liable to a supplementary tax at a progressive tax rate ranging from 0.1% to 1% with a tax free threshold of €300,000 of the total value of property rights subject to ENFIA, excluding the value of plots outside urban planning (agricultural plots). The supplementary tax on legal entities or other entities is imposed at a tax rate of 5‰ on the total value of property rights subject to ENFIA, not taking into account the value of rights on properties that are exempt and the value of property rights on buildings and plots that are self-used for the production or the exercise of any business activity, irrespective of the object of business.

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.4223/31.12.2013, 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

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 recognized stock exchange.

Real Estate Mutual Funds (REMF)

A real estate mutual fund is managed by a fund management company, or *Anonimi Eteria Diahirisis Amiveon Kefaleon* (AEDAK), formed as an SA, which must have a minimum paid-in share capital of at least €2,935,000 (art.2 para. 5a). 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. (art. 5 para. 2a).

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. (art. 6 para. 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 (art. 6 para. 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 (art. 11 para. 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 (art. 22 para. 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 25% 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 (art. 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% (art. 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. 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 an REIC is not exempt from capital gains tax.

No real estate transfer tax is imposed in the case of REICs resulting from mergers or conversions. REITs are subject to the Uniform Tax on the Ownership of Real Estate Property (see above). In relation to the supplementary tax, REITs are subject to a **reduced rate of 2.5‰** imposed on the total value of the rights to property, with the exception of property that is self-used by REITs.

Withholding tax on dividends

By virtue of the provisions of L. 4172/2013 a 10% 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 also some associations) to individuals or legal entities, Greek or foreign (application for distributed profits approved as of 1 January 2014 onwards).

Dividends distributed by REICs are not subject to the 10%[4] withholding tax.
For dividends received by REICs, the 10% 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. Pursuant to a rule introduced with L. 4172/2013 on the abuse of provisions on the transfer and setoff of losses, in cases where the direct or indirect ownership or voting rights of an enterprise are changed at a percentage exceeding 33% during a tax year, the carry forward of tax losses ceases to apply, unless the taxpayer can prove that the change in ownership occurred for commercial or business purposes.

Special merger incentives for real estate companies

By application of L. 2166/1993 and L.D 1297/1972, the merger between real estate companies is exempt from the real estate transfer tax.

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.

[4]Based on a draft bill submitted to the Greek Parliament, an increase of the dividends tax rate to 15% is proposed.

- Taxes and duties paid to the local authorities directly or indirectly (e.g. 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.

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.

Please note that 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 (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.

Duties on restaurant bills

A municipal and community duty of 2% 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 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.

Tax on sales of beer

According to Greek legislation, a tax is imposed on beer sold in Greece. It is calculated at a rate of 3% on the value of beer sold by the producer or his representative. The duty is payable by the purchaser and is collected by the producer, who is responsible for the payment of the tax to the tax authorities. It is to be noted that as from 19 August 2015 said tax is imposed for the benefit of the Greek State and not the municipalities.

It should be noted that the aforementioned tax could be incompatible to the article 3 para. 2 of the Directive 92/12/EEC on the general arrangements for products subject to excise duty, as interpreted by the ECJ (C-434/97, C-437/97). However, its compatibility with EC law has not been disputed until now.

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 pecuniary rate ranging between 0.15% to 0.3% and 0.15% to 0.2% when the water is mixed with other juices. 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.

Contacts

Advisory
Kyriacos Andreou
Tel: +30 210 6874680
E-mail: kyriacos.andreou@gr.pwc.com

Assurance
Nicos Komodromos
Tel: +30 210 6874671
E-mail: nicos.komodromos@gr.pwc.com

Tax & Legal
Vassilios Vizas
Tel: +30 210 6874019
E-mail: vassillios.vizas@gr.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Hong Kong

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Hong Kong 3

Contacts 7

All information used in this content, unless otherwise stated, is up to date as of 10 April 2016.

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%. 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 D**uty on transfer of properties. .

Ad valorem stamp duty

Unless specially exempted, the transfer of Hong Kong property (residential and non-residential) whereby the agreement is executed on or after 23 February 2013 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 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.

Period within which the residential property is resold or transferred after its acquisition	SSD Rates (for residential property acquired on or after 27 October 2012)
6 months or less	20%
More than 6 months but for 12 months or less	15%
More than 12 months but for 36 months or less	10%

All parties to a contract are liable to the SSD.

***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.

Contacts

Advisory
Winnie Liu
Tel: +852 22892488
E-mail: winnie.liu@hk.pwc.com

Assurance
Alan Ho
Tel: +852 22892168
E-mail: alan.ho@hk.pwc.com

Tax
KK So
Tel: +852 22893789
E-mail: kk.so@hk.pwc.com

Jacqueline Wong
Tel: +852 22893706
E-mail: jacqueline.sy.wong@hk.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global India

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax & Regulatory Summary – India 3

Real Estate Investments – India 5

Contacts 22

All information used in this content, unless otherwise stated, is up to date as of 22 April 2016.

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 Indian Government in recent times. On 6 May 2015, the Union Cabinet approved inclusion of REITs as an eligible financial instrument under the exchange control regulations. The Reserve Bank of India (RBI) vide notifications dated 16 November 2015 and 15 February 2016 notified the much awaited regulatory policy enabling foreign investments under the automatic route in REITs regulated by the Securities and Exchange Control Board of India (SEBI).

Applicable taxes

Under the Indian Income-tax Act, 1961 (the Act), 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 provided 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. However, there is a proposal to phase out certain Income-tax incentives in line with an overall view to bring down the corporate tax rate.

Capital gains earned on transfer of property are taxable as either short term capital gains (if property held for up to 36 months) or long term capital gains (if held for more than 36 months), taxable at 30% (plus applicable surcharge and education cess) and 20% (plus applicable surcharge and education cess) respectively. Sale of properties without consideration or nominal consideration may be subject to taxation at a deemed value.

Capital gains earned on transfer of securities[1], by a non-resident, is taxable either as short term capital gains (if property held for up to 36 months) at 40% or long term capital gains (if held for more than 36 months) at 10%[2] (plus applicable surcharge and education cess) for unlisted securities and 20% otherwise.

The taxation regime for REITs has further been rationalized by proposals set forth in the Union Budget for financial year 2016-17 announced by the Finance Minister on 29 February 2016. The Budget proposals are expected to be passed into law upon receiving the President's assent, which is expected in May/ June 2016, and there is an effective pass through.

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.

---

[1] 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. Tax implications, where securities are listed on stock exchange in India are not considered.

[2] Under the extant provisions, long term capital gains arising on transfer of securities, whether listed or unlisted, are taxed at 10%. With a view of clarifying the position, the Finance Bill, 2016 proposes to amend the provisions of section 112(1)(c)(iii) of the IT Act that long term capital gains arising from transfer of shares of private company shall be charged at 10%.

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

Under the FDI route, a person resident outside India is allowed to invest in 'permitted securities'. Permitted securities include equity shares, compulsorily convertible preference shares and compulsorily convertible debentures issued by an Indian company. Further, a SEBI registered Foreign Portfolio Investor (RFPI) can invest in listed non-convertible debentures issued by an Indian company.

100% FDI in construction and development projects is permitted under the automatic route. The investment is subject to certain investment and project-related guidelines as follows:

- Each phase of the project would be considered as a separate project.
- The foreign investor is now permitted to exit and repatriate foreign investment on completion of project or trunk infrastructure or completion of a lock in period of 3 years, whichever is earlier. Lock in period shall be calculated with respect to each tranche of foreign investment.
- Transfer of stake from one non-resident to another non-resident can be undertaken without any lock in condition.
- The lock in condition is not applicable to Hotels & Tourist Resorts, Hospitals, SEZs, Educational Institutions, Old Age Homes and investment by NRIs.

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 3 years.

Real estate business is defined as dealing in land and immovable property with a view to earning profit.

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.

FDI policy on Limited Liability Partnerships (LLPs) has been recently amended to provide that investments in LLPs will not require Government approval. 100% FDI is now permitted under the automatic route in LLPs operating in sectors/ activities where

100% FDI is allowed, through the automatic route and there are no FDI-linked performance conditions.

FDI is permitted under the automatic route without being subject to aforementioned **conditionality's in SEZ**s, Hotels and Tourist Resorts, Hospitals, Educational Institutions, Old Age Homes and investment by NRIs.

FDI is also allowed up to 100% in industrial parks under the automatic route. The conditions specified above 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.

However, FDI is prohibited in an entity engaged in dealing in land and immovable property, construction of farm houses and trading in transferable development rights.

Regarding the FDI policy, the government has provided guidelines for:

- Calculation of total foreign investment – ie, direct and indirect foreign investment in Indian companies;
- Transfer of ownership or control of Indian companies in sectors with caps from resident Indian citizens to non-resident entities;
- Downstream investments by Indian companies and LLPs (which have FDI).

External commercial borrowings

The RBI has recently issued a Circular outlining the new framework[3] for External Commercial Borrowings (ECBs), replacing the existing guidelines issued about a decade ago. The overarching principle of the new framework has been to liberalise and encourage long term ECBs denominated in foreign currency and ECBs denominated in INR.

Under the new framework:

- Companies in infrastructure sector, REITs and Infrastructure Investment Trusts (InvITs) registered with SEBI are allowed to raise ECBs in foreign currency (covered under Track II of the new framework). The Minimum Average Maturity (MAM), irrespective of the amount, would be 10 years.
- Companies in infrastructure sector, REITs and InvITs registered with SEBI and SEZ Developers4 are allowed to raise ECB in INR (covered under Track III of the new framework). The MAM would be as below:

---

[3] ECB Policy – Revised Framework published vide A.P. (DIR Series) Circular No. 32 dated 30 November 2015.

[4] SEZ Developers can use ECBs only for providing infra-structure facilities within the SEZ.

- Up to USD 50m or its equivalent: 3 years.
- Beyond USD 50m or its equivalent: 5 years.

Key remarks:

- Infrastructure sector borrowers now need to comply with 10 years MAM, unless ECB is denominated in INR.
- REITs/ InvITs are now eligible to raise ECB under Track II and/ or Track III of the new framework.
- SEZ developers, hitherto under approval route, are now covered under automatic route under Track III of the new framework.
- LLPs are still not included in the list of eligible borrowers.

Other conditions:

- The all-in-cost requirement for ECB covered under Track II and III are as under:
- Track II – Maximum spread of 500 basis points per annum over the benchmark.
- Track III – In line with the market conditions.
- Permitted end-use for ECB falling under Track II and III – Any end-use other than the following:
  - Real estate activities.
  - Investing in capital market.
  - Using proceeds for equity investment domestically.
  - On-lending to other entities with any of the above objectives.
  - Purchase of land.

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 or a Chartered Accountant 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.

NRI investments, both in individual capacity and through an overseas trust, company or partnership firms owned and controlled by NRIs, made under Schedule 4 of FEMA (Transfer or Issue of Security by Persons resident outside India) Regulations will be considered as domestic investment.

Acquisition and transfer of immovable property

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 in foreign exchange received through normal banking channels, or out of funds held in a Foreign Currency Non-Resident (FCNR) account; 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 Non-Resident External Account for acquisition of the property.

- In the case of residential property, the repatriation of sale proceeds is restricted to the Indian 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, under the Portfolio

Investment Scheme (PIS) without any prior Foreign Investment Promotion Board (FIPB)/RBI approval subject to fulfilment of inter alia the following conditions:

- Total paid-up value of shares/convertible preference shares/convertible debentures/warrants purchased by NRI both on repatriation and non-repatriation basis does not exceed 5% of the paid-up value of shares/convertible preference shares/convertible debentures/warrants of an Indian company.

- The aggregate paid-up value of shares/convertible preference shares/convertible debentures/warrants purchased by all NRIs in the Indian company does not exceed 10% of the paid-up value of the Indian company. The ceiling of 10% can be raised to 24% through a special resolution passed by the Indian company.

Acquisition of securities or units by NRI on non-repatriation basis

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

- 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 Mutual Funds (REMFs)

The SEBI has amended SEBI (Mutual Fund) Regulations, 1996 (vide notification dated 16 April 2008) to permit mutual funds (MFs) to launch REMFs, the Indian form of REITs. The salient features of REMFs are:

- REMF means a scheme of a mutual fund, which has the investment objective to invest directly or indirectly in Real Estate Asset.

- **'Real Estate Asset' has been defined as an immovable** property that is situated in a city notified by SEBI or in an SEZ, on which construction is complete and is usable with clear title and is free from all encumbrances and litigation and freely transferable. There are specific exclusions such as vacant land, land specified for agricultural, project under construction, deserted property and property which is reserved or attached pursuant to orders of a court of law or the acquisition of which is otherwise prohibited under law.

- Existing MFs are eligible to launch REMFs if they have adequate number of experienced key people/directors and sponsors should have a minimum five-year experience in the real estate business. Other criteria applicable for sponsoring an MF shall continue to apply.

- The REMFs shall be close-ended schemes and its units shall be listed on a stock exchange with net asset value being declared daily.

- At least 35% of the net assets of the scheme will be invested directly in real estate assets. The balance can be invested in specified securities and shares of companies engaged in real estate business. No more than 75% of the net assets of the scheme can be invested in real estate assets, and real estate-related securities (including mortgage-backed securities).

- The REMFs shall appoint a custodian who shall be duly registered with SEBI to keep custody of title deeds of the assets.
- Each real estate asset is required to be valued every 90 days by two valuers, accredited by a credit rating agency registered with SEBI.
- Caps are imposed on investment in a single city, single project, securities issued by sponsor/associate companies, etc.
- Transfer of real estate assets among various schemes of an MF are not allowed.
- REMFs cannot undertake lending or housing finance activities.

The amended regulations also specify accounting and valuation norms related to the scheme.

Currently, there are no REMFs registered with the SEBI. While applications for REMFs registrations have been made by certain real estate players, these are under consideration by SEBI for approval.

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.
- A REIT needs to be registered with SEBI.
- A maximum of three Sponsors are permitted to set-up the REIT.
- The Sponsors collectively should have a net worth of not less than 1,000m INR and individually not less than 200m INR.
- The manager of the REIT should have a minimum net worth of 100m INR.
- It is mandatory for all units of REIT to be listed on a recognised stock exchange
- At the time of initial offer, value of the assets owned by REIT should be at least 5,000m INR and the offer size should be at least 2,500m INR.

- 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 3 years after initial offer. Units exceeding 25% shall be subject to a lock in of 1 year after initial offer.
- REIT can invest either directly in or indirectly in real estate assets in India.
- The real estate properties or securities acquired must be in the territory of 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.
- At least 80% of the REIT should be represented by completed and rent generating assets.
- A REIT shall hold at least 2 projects, directly or through SPV, with not more than 60% of the consolidated value of assets in one projects.
- Maximum of 20% of the value of the REIT can be represented by – under construction properties5, listed or unlisted debt of real estate companies, mortgaged backed securities, equity of listed Indian companies and government securities.
- At least 75% of the revenue should be from rental or leasing of assets, or incidental revenue.
- Investment in other REITs or lending not permitted.

Regulatory framework

- Foreign investment permitted in REITs

Persons resident outside India, including RFPI and 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.

However, the non-resident unitholder may not be able to exit investments in units of REITs by exercising an option/ right to exit.

Further, these units could be pledged by the non-resident unitholder to secure credit facilities.

---

[5] Aggregate of investments shall not exceed 10% of the total REIT assets.

- 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.

- Definition of 'real estate business'

In the Foreign Exchange Management (Permissible Capital Account Transactions) Regulations, 2000, 'real estate business' has been regarded as a prohibited sector for foreign investment.

These regulations have now been amended to exclude REITs registered and regulated under the extant SEBI regulations, from the ambit of 'real estate business'. This potentially enables the REITs from directly buying (and selling) real estate.

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.
- All project measuring more than 500 sq. mts or more than 8 apartments will have to be registered with the Regulatory Authority to be prescribed in this regard.
- Commercial real estate also brought under the ambit of the Real Estate Act.
- 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.

---

[6] Sponsor, Manager, Investment Manager can be organized in the form of a LLP.

- Liability of developers for structural defects have been increased from 2 to 5 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).

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 characterized as business income and taxable at applicable rates, on a net income basis. Development and borrowing cost 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. Generally, Indian companies are required to follow percentage completion method for recognizing income and accruing expenses.

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 capitalized 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 characterized 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.

Characterization 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.

Sale of properties

Sale of properties held as capital assets (ie, not developed or held with purpose of selling), is taxable as capital gains. Where the property is held for more than 36 months the same is characterized 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).

Anti-abuse provision

Sale of properties 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).

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 at 21.34% is payable by the Indian company.

MAT credit is available to be carried forward for 10 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, or WDV, of the building. Land is not depreciable. If the building is held as private property, no depreciation is allowable. 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'**.

Amendments proposed in the Finance Bill, 2016 – Incentives for promoting affordable housing

With a view to provide affordable housing as part of the larger objective of **'Housing for all',** the Government has proposed to amend the Act to provide 100% deduction of profits of a tax payer developing and building affordable housing projects, if such housing project is approved by competent authority after 1 June 2016 but before 31 March 2019 subject to certain conditions. However, MAT to apply.

This amendment is proposed to be effective from Assessment Year 2017-18 onwards.

- Profit linked incentives for SEZ developers to be phased out for development of SEZs commencing from financial year 1 April 2017.
- Profit linked incentives to SEZ units to be phased out for units commencing activities from financial year 1 April 2020.
- Additional interest deduction for housing loans availed by first time individual home buyers up to 50,000 INR subject to certain conditions.

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[7]/ 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 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 36 months and 30% (plus applicable surcharge and education cess), if the securities8 were held for up to 36 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 36 months. Since the regulations provide for a lock in of 3 years, tax implications, in a scenario where the property is transferred prior to 3 years, is not considered.

---

[7] The company declaring dividend is liable to pay dividend distribution tax (DDT) at the rate of 15% plus surcharge at 12% and education cess at 3% on applicable tax and surcharge. In order to further rationalize the taxation regime for REITs, Finance Bill, 2016 proposes to provide an exemption from the levy of DDT in respect of dividend declared, distributed or paid by the SPV to the business trust, subject to prescribed conditions.

[8] Tax implications, where securities are listed on stock exchange in India are not considered.

- Any other income of the REIT, would be chargeable to tax at the rate of 30% (plus applicable surcharge and education cess).

Withholding tax on distributions

Resident Investors

Where the REIT distributes the income received by it, by way of interest from the SPVs or lease rentals, to a resident unit holder, the REIT is required to withhold tax at the rate of 10%.

Non-resident Investors[9]

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).

Any other income distributed by the REIT ought not to be taxable in the hands of the investors.

The tax withheld, as discussed above, should be available as credit.

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, held for more than 36 months, are exempt from tax subject to payment of Securities

Transaction Tax (STT)

Capital gains on transfer of units listed on a recognised stock exchange in India, held for up to 36 months, are chargeable to tax at the rate of 15% (plus applicable surcharge and education cess) subject to payment of STT.

Non-resident investors[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) in the case of individuals and 5% (plus applicable surcharge and education cess) in the case of corporates.

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

---

[9] Availability of treaty benefits, if any, have not been considered.

of individuals and a rate of 40% (plus applicable surcharge and education cess), in the case of corporates.

The tax withheld, as discussed above, should be available as credit.

Tax implications on capital gains from the sale of the units in the REIT are discussed below

Capital gains on transfer of units listed on a recognised stock exchange in India, held for more than 36 months, are exempt from tax subject to payment of STT.

Capital gains on transfer of units listed on a recognised stock exchange in India, held for up to 36 months, are subject to tax at the rate of 15% (plus applicable surcharge and education cess), in case of individuals and 15% (plus applicable surcharge and education cess), in case of corporates, subject to payment of STT.

Sponsor

As regards the Sponsor, the swap of shares in an SPV for units in a REIT is a transaction exempt from tax.

However, where 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 36 months, the rate of tax is 20% (plus applicable surcharge and education cess), and held for up to 36 months, the rate of tax is 30% (plus applicable surcharge and education cess).

MAT at the rate of 18.50% (plus applicable surcharge and education cess) for Sponsor being a corporate entity would be applicable. A separate computation mechanism is prescribed for calculation of MAT, with respect to the Sponsor.

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 40% (plus applicable surcharge and education cess).

Dividend is exempt from tax in the hands of the recipient. However, Indian company distributing dividend is subject to DDT[10].

Interest income is usually taxable at 20% to 40% (plus applicable surcharge and education cess). In certain specified cases, Interest income could be subject to concessional rate of 5% (plus applicable surcharge and education cess) subject to fulfillment of certain conditions.

---

[10] At the rate of 15% plus surcharge at 12% and education cess at 3% on applicable tax and surcharge.

Transfer pricing

The Indian transfer pricing code provides that the price of any international and specified domestic transaction between associated enterprises is to be computed with regard to the arm's length principle. However, the transfer pricing legislation is not applicable when the computation of the arm's length price has the effect of reducing income chargeable to tax or increasing losses in India. This is aligned with the legislative intent to protect the Indian tax base.

Losses carried forward

Losses from letting out of one property can be used to offset rental income from other properties in the same year, and thereafter against other types of income, such as business, interest, capital gains, etc, in the same year. 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 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 General Anti Avoidance Rule 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 will 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.

Indirect Taxes

Indirect taxes in India include taxes / duties at the central level such as Customs duty on import of goods, Excise duty on manufacture of goods, Central sales tax on interstate sale of goods and service tax on services rendered and taxes at state level such as value-added tax (VAT) on local sale of goods in a state.

We have provided below an overview of the two main taxes applicable for the real estate industry ie, Service tax and VAT.

Service tax

Service tax at the rate of 14% and 2 cesses at the rate of 0.5% are levied on the gross value of taxable services which makes the effective rate of service tax 15% (with effect

from June 1, 2016). Service tax is charged by the service provider and is recovered from the recipient of service. However, in certain cases, service tax is payable by service receiver under the reverse charge mechanism.

With respect to the real estate sector, service tax applies on most services rendered such as construction, property management and maintenance, renting on immovable property for commercial purposes, services of real estate agents, architects, etc. Service tax does not apply on renting of immoveable property for a residential dwelling and services which are specifically exempted.

Construction projects typically qualify to be 'works contracts' on which service tax applies on the service portion and state level VAT applies on the goods involved in such construction activity. For payment of service tax, different options are available for computing the value of services for payment of service tax. These include adopting a prescribed standard value of the services, claiming actual deduction of goods involved in the construction or claiming an abatement in the value of services at the prescribed rates.

Services provided to SEZ developers and SEZ units are either exempted from the payment of service tax or refunded to the SEZ developers/ SEZ units

Value-added tax (VAT)

Value-added Tax is levied by states on sale of goods in a state. The tax rate, varies from state to state.

VAT, in addition to service tax, is payable on construction activities. For arriving at the taxable value and payment of VAT, state VAT laws normally provide for various deductions such as actual or standard deductions towards value of labour and like charges, deductions for payments to sub-contractors, etc. Further, most states provide for an option to pay VAT under composition scheme on total sale value at composition rate typically at the rate of 4% subject to no input tax credits being taken.

Some state VAT laws provide either for an exemption or refund to goods sold to SEZ developers/SEZ units.

It may be noted that VAT and Service Tax do not apply on sale or purchase of land or on the value of land in any construction project.

Goods and Services Tax (GST)

The Goods and Services Tax (GST) has been the most awaited tax reform in India. The present taxation system in India allows for a heterogeneous tax structure whereby different States in India have different tax laws and local levies. The introduction of GST seeks to overhaul the present taxation system by taxing both goods and services and is likely to have significant advantages to the trade and industry which among others would include free flow of credits in the supply chain, reduction in cost of production and encourage exports. It is thus expected that GST would be a comprehensive consumption tax in the true sense.

For the real estate sector, it is expected that GST would bring about considerable simplification in the manner in which taxes would be paid. Further, there would be significant changes in key tax concepts such as taxable event, valuation of goods and services, place of supply of goods and services, rates of tax, compliance and reporting

requirements, etc which are likely to impact (mostly favourable) several aspects of real estate business.

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.

Contacts

Advisory

Sanjeev Krishan
Tel: +91 124 330-6017
E-mail: sanjeev.krishan@in.pwc.com

Shashank Jain
Tel: +91 22 6689-1004
E-mail: shashank.jain@in.pwc.com

Tax

Gautam Mehra
Tel: +91 22 6119-8051
E-mail: gautam.mehra@in.pwc.com

Abhishek Goenka
Tel: +91 80 4079-6279
E-mail: abhishek.goenka@in.pwc.com

Akash Gupt
Tel: +91 124 330-6509
E-mail: akash.gupt@in.pwc.com

Bhairav Dalal
Tel: +91 22 6689-1130
E-mail: bhairav.dalal@in.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
Ireland

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Ireland 3

Real Estate Investments – Ireland 5

Contacts 24

All information used in this content, unless otherwise stated, is up to date as of 20 April 2016.

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 a minimum period of 7 years.

Real Estate Investments – Ireland

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.

The following is a broad outline of the taxation framework in Ireland, and the tax issues associated with property investment in Ireland. However, it should only be treated as a general guide and detailed advice should be taken when considering any property investment.

The taxation framework in Ireland

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 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.

Corporation tax system in Ireland

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 residency and the scope of Irish tax

A company resident in Ireland for tax purposes ('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.

The tax base in Ireland

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 in Ireland

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.

Corporation 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 with 72 countries, of which 70 are currently in effect. New agreements have been signed with Zambia, Thailand, and Ukraine and are effective from 1 January 2016. A Protocol to the existing Double Taxation Agreement with Germany and Luxembourg was ratified by Ireland in 2015. These Protocols are effective from 1 January 2016.

The Irish Double Taxation Agreement network continues to be expanded and updated.

Negotiations for new Double Taxation Agreements with Azerbaijan, Kazakhstan and Turkmenistan and for a Protocol to the existing Double Taxation Agreement with Mexico have concluded; these are expected to be signed shortly. The new Double Taxation Agreement with Botswana, will enter into effect in Ireland on 1 January 2017. Negotiations for a replacement Double Taxation Agreement with the Netherlands are ongoing.

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 Double Taxation Agreements 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 Double Taxation Agreement (and whose companies are not under the control of Irish residents)
- Companies resident in non-EU countries, or countries with which Ireland does not have a Double Taxation Agreements, 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.

The 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 in Ireland

Formal transfer pricing legislation was introduced in Ireland in 2010. The new 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 the new 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. The new rules are effective for accounting periods commencing on or after 1 January 2011, and apply to arrangements entered into on or after 1 July 2010. There is, however, an exemption available for small and medium sized enterprises.

Value-added tax (VAT) – An Overview

In common with all EU Member States, Ireland operates a consumption tax known as value-added tax (VAT). VAT is charged on the supply of most goods and services. Businesses that carry on activities that are chargeable to VAT are required to register with the Irish Tax Authorities (certain registration thresholds apply) and account for VAT at the appropriate rate in respect of revenues derived from the supply of goods and services. In practice, VAT is not a cost for most businesses as it may be passed on to customers. Furthermore, 'accountable persons' (ie, persons who charge VAT on the supplies of their goods and/or services) can offset the VAT incurred on the purchase of goods and services (with certain exceptions) against the VAT charged

on their sales. As a result, there is generally no VAT cost to a business whose activities are fully VAT-able. For this reason, VAT is generally described as a consumption tax since the ultimate cost rests with non-business users or business users engaged in VAT-exempt activities.

Exempt businesses (such as banking and insurance) are typically not required to account for VAT on such supplies of services, and consequently are unable to recover any VAT incurred on related purchases of goods and services (subject to certain exceptions).

A reclaim of VAT incurred on the following items is specifically prohibited:

- The purchase, lease, hire, acquisition or importation of passenger motor vehicles (except where such vehicles are considered to be inventory).
- The purchase of petrol (except where the petrol is considered to be inventory).
- Entertainment, food, drink, accommodation, or other personal services.

Sales of goods from Ireland which are dispatched to VAT-registered customers in another EU Member State, or exports to persons outside of the EU, are zero-rated.

Companies predominantly involved in the export of goods will tend to be in permanent VAT refund position (ie, VAT incurred on costs consistently exceeds VAT on sales). To eliminate this cash-flow cost, Ireland provides a unique regime for businesses whose revenues are at least 75% derived from the supply of goods to VAT-registered customers in other EU Member States, or to customers outside the EU. Such businesses may obtain authorisation from the Irish Tax Authorities to purchase most goods (including imports) and services, free of VAT. On receipt of the authorisation (known as VAT 56B Authorisation), the business gives a copy of this document to its suppliers and these suppliers are then permitted to apply 0% VAT to all supplies (with some limited exceptions), irrespective of the rate that would otherwise apply. The authorisation is available only to companies whose primary business activity is the supply of goods (as defined for VAT purposes). Companies whose primary activity is the supply of services do not qualify for this facility.

A business that is not established or registered for VAT in Ireland but which incurs Irish VAT, may recover that VAT from the Irish Tax Authorities by filing a claim with the Tax Authorities in the jurisdiction in which the business is VAT registered and established**. This facility is known as 'Electronic VAT Refund' (EVR). EVR is** also available, via Revenue Online Services (ROS) to Irish VAT registered and established businesses that incur VAT in other EU Member States (where they are neither VAT registered nor established). Non-EU established businesses may claim by way of the EU Thirteenth Directive. A refund of VAT on the specific non-deductible items, as outlined above, is prohibited.

An administrative arrangement known as a 'VAT 60B' exists to enable Irish service providers to charge Irish VAT at 0% on continuous services supplied to certain foreign business customers. The authorisation is sent to the foreign business customer and in effect the supplier charges VAT at 0% on the particular service identified on the VAT 60B. This facility is of cash-flow benefit to the foreign customer who would otherwise have to make an EVR/Thirteenth Directive reclaim. As a result of change in place of supply rules for services effective since 1 January 2010, the VAT60B mechanism is used only in limited circumstances.

Details of the current VAT rates are available on page 24 of the most recent edition of PricewaterhouseCoopers' publication Tax Facts (PwC 2016 Tax Facts - click here) 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:

- Rents and rates payable on the property.
- The costs of any goods/services that the lessor is obliged to provide under the terms of the lease.
- The costs of maintenance, repairs, insurance and management of the property.
- Interest on money borrowed to purchase, improve or repair the property.

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 dependant 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 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;

- 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 the minimum 7 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 CGT '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.

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)
- 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.

Transfers of most other forms of property, including commercial property and intangible assets, attract duty at 2%.

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.

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.

Municipal tax system in Ireland

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:

Estimated rental value	€ 50,000
Adjust by percentage, eg,	0.5%
Rateable value	€250

Rateable valuations are determined by the Valuation Office, which is independent of the local authorities, but is ultimately controlled by Government. Where a person is not satisfied with the valuation of their property they have the right to appeal through a formal appeals process.

Rateable valuation multiplier

The rateable valuation multiplier is fixed each year by the relevant county or city council. The multiplier will also depend on whether a revaluation has been carried out in that local authority yet. For illustrative purposes a sample of rateable valuation multipliers is set out below:

City	Multiplier (2016)
Cork	74.05
Galway	67.40
Dublin	0.2560
Limerick	0.2459
Waterford	0.2520

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

Rateable value	€250
Multiplier applying in 2016	74.05
Annual rates liability	€18,512.50

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

Rateable value	€100,000
Multiplier applying in 2016	0.2560
Annual rates liability	€25,600

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 Local Property Tax (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. If a property is valued at €1 million or lower, the tax is based on the mid-point of the relevant band. For properties valued over €1 million the tax is charged on the balance over €1 million. The basic LPT rate was set at 0.18% for properties valued under €1 million and 0.25% on the amount of the value over €1 million.

Local Property Tax Table			
Valuation band (€)	Mid-point (€)	Standard rate (%)	Standard LPT payment (€)
0 - 100,000	50,000	0.18	90
100,001 - 150,000	125,000	0.18	225
150,001 - 200,000	175,000	0.18	315
200,001 - 250,000	225,000	0.18	405
250,001 - 300,000	275,000	0.18	495
300,001 - 350,000	325,000	0.18	585
350,001 - 400,000	375,000	0.18	675
400,001 - 450,000	425,000	0.18	765
450,001 - 500,000	475,000	0.18	855
500,001 - 550,000	525,000	0.18	945
550,001 - 600,000	575,000	0.18	1,035
600,001 - 650,000	625,000	0.18	1,125
650,001 - 700,000	675,000	0.18	1,215
700,001 - 750,000	725,000	0.18	1,305
750,001 - 800,000	775,000	0.18	1,395
800,001 - 850,000	825,000	0.18	1,485
850,001 - 900,000	875,000	0.18	1,575
900,001 - 950,000	925,000	0.18	1,665
950,001 - 1,000,000	975,000	0.18	1,755
Properties worth more than €1 million are assessed on the actual value at 0.18% on the first €1 million and 0.25% on the portion above €1 million.			

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 2016, Revenue must have been notified of the local adjustment factor on or before 30 September 2015. 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.

Contacts

Advisory
Declan McDonald
Tel: +353 1 792-6092
E-mail: declan.mcdonald@ie.pwc.com

Assurance
Joanne Kelly
Tel: +353 1 792-6774
E-mail: joanne.p.kelly@ie.pwc.com

Tax & Legal
Enda Faughnan
Tel: +353 1 792-6359
E-mail: enda.faughnan@ie.pwc.com

Tim O'Rahilly
Tel: +353 1 792-6862
E-mail: timothy.orahilly@ie.pwc.com

Ronan MacNioclais
Tel: +353 1 792-6006
E-mail: ronan.macnioclais@ie.pwc.com

Hugh Campbell
Tel: +353 1 792-6845
E-mail: hugh.campbell@ie.pwc.com

Ilona McElroy
Tel: +353 1 792-8768
E-mail: ilona.mcelroy@ie.pwc.com

Graham Owens
Tel: +353 1 792-7809
E-mail: graham.owens@ie.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Israel

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Israel 3

Contacts 9

All information used in this content, unless otherwise stated, is up to date as of 9 May 2016.

Real Estate Tax Summary – *Israel*

General

A foreign investor may invest in Israeli real estate directly, or through an Israeli or foreign company 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 2016, companies are taxed at the corporate tax rate of 26%. (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 (2016), regular profits of 100 for an Israeli company will provide a net, ie, after tax, dividend income of 52.5 (56.25 where the 25% WHT rate applies). This is 100, minus 25 company tax and 22.5 dividend WHT, assuming the absence of a reduced rate due to a treaty.

Individuals are taxed at rates of 30% to 48% 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 48% 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 5,030). 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 25%. 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 48**% (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 realized as from 1996 might be used to offset capital gains, including land appreciation, realized 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 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 25% (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.
- 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:

Regular rate	6 %
Apartment/house intended for residential use (first and only home)	0%[1]
and exceeding the amount of 1,568,800 ILS	3.5% to 10%[2]
Apartment/house intended for residential use (additional home)	5% to 7%[3]
New immigrants – apartment/house and business. Premises special concessionary rate subject to conditions	0.5% and 5%

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.

[1] up to ceiling of approximately 1,421,760 ILS

[2] These reduced rates apply where the unit is the only dwelling owned by the individual or where in the 24 months after the purchase, the individual sold another dwelling unit which had been his only dwelling unit [12 months where the unit was purchased from a building contractor – detailed rules apply].

[3] 5% up to ceiling of 1m ILS, 6% for the part of consideration exceeds 1m ILS and up to 3m ILS, and 7% for the part of consideration exceeds 3m ILS.

Contacts

Tax

Shaul Ben-Amotz
Tel: +972 3 7954489
E-mail:shaul.ben-amotz@il.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Italy

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Italy 3

Real Estate Investments – Italy 6

Contacts 46

All information used in this content, unless otherwise stated, is up to date as of 02 May 2016.

Real Estate Tax Summary – *Italy*

General

In the Italian tax system, real estate property is generally deemed to produce taxable income, even if not used by the owner or even if not leased out. This income is subject to taxation in the hands of the owner of the real estate, in property or by virtue of another real right, according to his nature and tax status, characteristics and use of the real estate.

Investments in 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 companies.

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 2.2%);
  - 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 2014-2017) 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.
- Companies

- Non-resident entities other than individuals (the resident ones are considered in the indirect investment) are subject to corporate income tax (IRES) with a rate equal to 27.5%, reduced to 24% from 2017[1] (the taxable base is the same ordinarily stated for individuals).
- Local property tax (IMU) is due and it is not deductible 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 27.5%, (reduced to 24% from 2017) 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, extraordinary items, 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 implications

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 investment possibilities

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*);
- 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;
- Investment into shares of an Italian SICAF (*Società di Investimento a Capitale Fisso*), an investment company with fixed capital.

Real Estate Investments – *Italy*

Direct investment in Italian real estate property

Legal aspects

Introduction

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) many, 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 info**rmation 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 0.9% to 1.4%, and a municipal surcharge, with rate up to 0.8%, 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, the local property tax (ie, IMU – see below) replaces IRPEF and local surcharges with regard to the income deriving from such properties (with some exceptions). Therefore, in this case, only IMU falls due.

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 2014-2017) 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).

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 27.5%, and reduced to 24% from 2017.

The taxable business income is computed by adding to the net civil result of the profit and loss (P&L) account of each tax period, any increasing or decreasing adjustment provided for by the business income tax rules.

Pursuant to the 'worldwide principle' on which the Italian tax system is based, as for resident individuals, the taxable income of resident corporate entities includes their worldwide income, ie, the income also sourced outside the Italian territory (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, revaluated by 5% and adjusted in consideration of the owning period incurred in the tax period, increased by one-third;
- for leased buildings, the highest amount between: (i) the cadastral income, revaluated by 5% and adjusted according to the owning period; and (ii) the rentals referring to the relevant tax period according to the lease agreements, reduced by a maximum 15% amount of the rentals for certain maintenance expenses actually incurred (expenses exceeding 15% of rentals are not deductible from income tax).

Therefore, expenses and other items concerning 'non-instrumental' buildings are generally not deductible with exclusion of interest expenses on financing for the acquisition of the buildings.

In 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 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. 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 and 4.75% for 2016. For the following years the rate is not defined yet. 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 e**xceeding 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.

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. It is worth noting that the Tax Office (by way of restrictive interpretation of the law) had tended to **limit the scope of this exclusion (i) to companies performing "passive" management of** real estate, (ii) provided that this loan has been granted specifically for the purchase or construction of such real estate. 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 als**o to 'industrial holding companies'** (ie, in general, companies with the majority of balance-sheet assets related to stakes in non-banking/non-financial entities).

Since this provision regulates interest expense deduction for IRES purposes, it does not apply to partnerships (which are transparent for income tax purpose).

Depreciation

As a general rule, land cannot be depreciated. Therefore, in order to determine tax-deductible depreciation, the cost of instrumental buildings has to be considered net

of the cost of the areas (land) on which such buildings are built/located and/or of those areas representing their pertinences. The cost of such areas, if not autonomously bought, is quantified as the greater of: (i) the balance-sheet value of the year of purchase (if any); and (ii) 20% of the total buildings' cost, increased to 30% for industrial buildings (defined as those used for the production and transformation of goods).

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 (ie, (i) financial stakes, securities and financial credits; (ii) buildings and certain other registered assets; (iii) other tangible and intangible assets). For these categories of assets the currently used coefficients (which signify the minimum profitability assumed for each category of assets) are, respectively, the following: 2%, 6% (reductions are provided in particular circumstances) and 15%.

In the event that the company is deemed non-operating, and any of the causes of exclusion provided do not apply, the main consequences are the following:

- Computation of minimum taxable base for income taxes purposes (both IRES and IRAP) by applying stated coefficients on the value for the year of the three above-mentioned asset categories (respectively: 1.5%, 4.75%, 12%, but reduced rates are provided in particular circumstances), regardless of the actual P&L account result for the year (as far as the minimum IRAP taxable base is concerned, some further rules have to be taken into consideration). 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 (ie, 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:

+	Gross proceeds from sales and services
+/-	Variations in inventory and work in progress
+	Other non-financial incomes
-	Cost of raw and other materials
-	Cost of services (administrative costs)
-	Depreciation of tangible and intangible assets
-	Other operating expenses
=	Value of production

The value of production also includes gains/losses deriving from disposal of real estate properties (even if non-instrumental or not directly used only for business purposes, and not representing stock inventory), unless the disposal intervenes in the context of a business or ongoing concern transfer which generates income not subject to IRAP.

Interest expenses (also those implicitly included in financial leasing rentals) and income are not included in the IRAP taxable base (in practice, they are, respectively, not deductible and not taxable). An exception is represented by the so-called industrial holding companies (ie, in general, companies with the majority of balance-sheet assets related to stakes in non-banking/non-financial entities): for these companies interest income and expenses (the latest up to 96%) form part of the IRAP taxable base.

Provisions for bad debt and devaluation on assets and on receivables do not have to be considered in computing the IRAP taxable base.

Labour costs are partially deductible, except labour costs concerning open-ended jobs that, from 2015, are fully deductible.

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 27.5% (reduced to 24% from 2017), 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 VAT (with the exception of non-buildable lands, never subject to VAT) if the vendor is a business undertaker or a professional taxpayer and 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 (ie, 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 according to the ordinary rules. In case of **seller's** option the VAT 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 option VAT 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 (eg, residential buildings having certain requirements; buildings, even under construction, sold by builders, certain restructuring works, etc).

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.

- 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 12%. 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%.

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.

Lease of property

Lease contracts concerning real estate properties 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.

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 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 new 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 levied upon the purchaser of the real estate. 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.

For inheritance tax and gift tax purposes, the same rates apply.

The applicable tax rates vary according to the specific relationship between the transferor subject (ie, the '*de cuius*' in the case of inheritance; the donor in the case of 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

IUC (Unified Municipal Tax)

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:

a) IMU, the Municipal Property Tax;

b) TASI, the Municipal Tax for Indivisible Services;

c) TARI, the Municipal Waste Tax.

a. 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).

b. 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, for 2016 the TASI rate can be increased to 0.25% 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.

c. 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

For personal income tax (IRPEF) purposes, the tax regime of dividends and capital gains varies according to whether they are related to 'qualified' participations or 'non-qualified' participations.

Participation is defined as qualified if it exceeds 5% of the capital, or 2% of the voting rights, of a company listed in a regulated stock market, or 25% of the capital and 20% of the voting rights in case of non-listed companies (including partnerships). These thresholds are tested over a 12-month period.

Resident individuals

Dividends collected by resident individuals with regard to non-qualified participations are subject to a 26% definitive WHT/substitute tax.

Conversely, dividends collected in respect of qualified participations are subject to ordinary IRPEF on 49.72% of the same, so they are exempt at 50.28%.

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.

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.

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 (ie, 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. Capital gains are not taxable in Italy in the following cases:

- If deriving from the sale, against consideration, of non-qualified participations 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 1.375%.

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 27.5% - 24% from 2017 – 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.

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 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 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 12% according to the nature of the contributed property.

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 (ie, 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*' (ie, filing, not required by the law, of the deed for the purpose of administrative activities/proceedings), or if it is mentioned in another document between the same parties which is subject to registration.

Mortgage loans are subject to mortgage tax, with a rate of 2% for the mortgage raising, 1% for its renewal and 0.5% for its cancellation.

Medium/long term loans (ie, longer than 18 months) executed in Italy by Italian banks, Italian branches of foreign banks (EU/non EU) or EU banks (even without an Italian branch) can benefit, upon option expressed in the loan agreement, from a substitute tax of 0.25% of the amount of the loan.

This 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) (For details, please 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).
- 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

Legislative Decree no. 28/2011 (published on the Official Gazette no. 71/2011, entered into force on 28 March 2011), implementing the Directive 2009/28/EC of the European Parliament and of the Council dated 23 April 2009 on the promotion of the use of energy from renewal, has introduced several amendments to Legislative Decree no. 192/2005. In particular, according to Legislative Decree no. 28/2011, it is now mandatory to insert in the rental agreements of immovables (or individual property units), a clause by which the tenant shall acknowledge the receipt of the information and documentation regarding the energetic certification of the buildings; such provision applies only to the buildings or to the property units already provided by an energy performance certificate, pursuant to Section 6, paragraph 1, 1-*bis*, 1-*ter* and 1-*quater* of Legislative Decree no. 192/2005.

Tax aspects

Income tax

See specific sections of '*Direct investment in Italian real estate property*'.

Indirect taxes

See specific 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).

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), 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).

Furthermore, proportional mortgage and cadastral taxes are levied at the time of purchase of the instrumental building 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 mortgage and cadastral taxes in fixed **amount (€**200 each) - For details 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

Legal aspects

See section 'Real estate enjoyment rights'.

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 2016, has stated at 0,2%) 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 lace 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 issued on 6 June 2001, no. 380, 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 issued on 19 August 2005, no. 192, 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 raging 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 27.5% (reduced to 24% 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 having no PE in Italy is subject to Italian taxation (IRES at a rate of 27.5%, reduced to 24% from 2017) in the tax period of realisation 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

See section '*Direct investment in Italian real estate property*'.

Real estate investment funds in Italy

Investment funds – General overview

Investment funds are 'instruments' for collective portfolio management. Pursuant to Legislative Decree no. 58 on 24 February 1998 (the Consolidated Law on Financial Intermediation), as lastly amended by Law Decree no. 78 on 31 May 2010, 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/ emphasized:

- 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 funds

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 of Italian real estate investment funds

The tax regime of Italian real estate investment funds (REIFs) is provided for by Law Decree 25 September 2001, no. 351 (converted with modifications by Law 23 November 2001, no. 410, as amended and integrated by several subsequent measures and lastly by Law Decree 13 May 2011, no. 70, converted with modifications by Law 12 July 2011, no. 106).

The Italian REIF is not subject to income taxes (Corporate Income Tax - IRES - and Regional Tax on Production - 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 (provided that the reciprocity condition with the relevant foreign Country is respected).

Law Decree no. 70/2011 has divided REIFs into two categories, each one with different tax regimes applicable to investors:

- Institutional REIFs;
- 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 (ie, ***Organismi d'I****nvestimento 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 (ie, private bodies and companies resident in Italy, which pursue specific mutuality purposes);

h) Corporate and contractual SPVs owned for more than 50% by any of the entities listed under the previous letters a) to g).

Foreign institutional investors under letter f) include: foreign States, foreign public bodies and foreign subjects corresponding to the listed Italian entities which are subject to 'prudential supervision'. This last requirement is met if the execution of the **foreign subject's activity requires prior authorisation and is subject to** compulsory continuous controls according to the laws in force in the foreign State of residence. The execution of this prudential supervision must be certified by the home **country's competent authority.**

The SPVs under letter h) can be established in Italy or abroad, but limited to countries included in the White List. The control on such SPV can also be indirect (in this case, the percentage of interest must be properly adjusted – eg, an indirect control on 60%

of a Luxembourg SPV through 90% of a US corporation, equates to 54% actual control on the 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 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.

REIFs – 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%).

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, UCITSs, REIFs, SICAVs), private wealth management subject to substitute tax regime.

SIIQs are required to annually distribute at least 70% of the net profit derived from the exempt business available for distribution. In practice, the distribution requirement applies to the net profit derived from: profits from the real estate rental business, profits from shareholdings in related SIIQs and SIINQs and (following 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 26% substitute tax (the rate was originally stated in 20%; however, since this substitute tax replaces the dividend withholding tax, which does not apply to repatriations by the permanent establishment to its foreign head office, starting from 1 July 2014 the applicable rate increased from 20% to 26%, as per dividend distributions to SIIQ shareholders).

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.

SICAF – a new Italian regulated investment vehicle

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, indirect taxes discounts and tax exemption or reduction for certain foreign investors - 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 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.

Contacts

Advisory

Antonio Martino
Tel: +39 (0) 2 66720612
E-mail: antonio.martino@it.pwc.com

Federico Colacicchi
Tel: +39 (0) 6 570253438
E-mail: federico.colacicchi@it.pwc.com

Assurance

Elisabetta Caldirola
Tel: +39 (0) 2 7785 309
E-mail: elisabetta.caldirola@it.pwc.com

Tax

Fabrizio Acerbis
Tel: +39 (0) 2 91605 004
E-mail: fabrizio.acerbis@it.pwc.com

Daniele Di Michele
Tel: +39 (0) 2 91605 002
E-mail: daniele.di.michele@it.pwc.com

Mario Joseph Feminò
Tel: +39 (0) 2 91605 010
E-mail: mario.joseph.femino@it.pwc.com

Legal

Giovanni Stefanin
Tel: +39 (0) 2 91605220
E-mail: giovanni.stefanin@it.pwc.com

Pietro Orzalesi
Tel: +39 (0) 2 91605 208
E-mail: pietro.orzalesi@it.pwc.com

Tommaso Tomaiuolo
Tel: +39 (0) 2 91605247
E-mail: tommaso.tomaiuolo@it.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global

Japan

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Japan 3

Real Estate Investments – Japan 5

Contacts 10

All information used in this content, unless otherwise stated, is up to date as of 27 April 2016.

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 34.81%. This tax consists of national corporate tax (23.40%), national "local corporate tax" (4.40%), 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 carryfoward 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 April 1, 2017.

In general, a company may use past losses to set off 65% of current year income. The amount of set off, however, is scheduled to decrease by 5% annually such that the limit will be 50% for fiscal years beginning on or after 1 April 2017).

There are a number of exceptions to these rules, with the primary exceptions described further below.

Withholding tax

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, ie, gross rent after the deduction of management expenses, depreciation, interest and other expenses, determined on an accrual basis.

The rate is currently approximately 34.81%. This tax consists of national corporate tax (23.40%), national "local corporate tax" (4.40%), 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 24.43% (including national local corporate tax) on net income.

If the foreign company has no PE in Japan, the rent is subject to withholding tax of 20.42%. The withholding tax is normally credited against the corporation's corporate tax liability when filing its Japanese corporate tax return.

In addition, when the foreign company without a PE sells real estate in Japan, the gross proceeds are subject to withholding tax at 10.21%, with such amount creditable when the tax return if 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 prior to April 1, 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 is only subject to corporate tax at the rate of 24.43% (including national local corporate tax).

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 10% where such property is held for five years or less, and 5% 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 2017.

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 is 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 24.43% (including national local corporate tax), 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 nine years. Also, the use of carried forward tax losses is limited to 65% of current year taxable income.

In addition, under the 2016 tax reform, the limitation for use of the loss carried-forward will decrease by 5% annually, and ultimately to be reduced to 50% for fiscal years beginning on or after 1 April 2017. The carryover period will be extended to ten succeeding years for losses incurred in fiscal years beginning on or after 1 April 2017.

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 2017 if the ownership change occurs in a purchase of the land.

A further reduction of the registration tax rate to 1.3% is applicable for TMKs and J-REITs under certain conditions, ie, where 75% or more of the assets of the TMK and J-REIT are real properties, and the properties are acquired on or before 31 March 2017 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 2018. 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 2018. 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 2017 (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 2018), 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 April 2017) 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.

Contacts

Advisory

Takeshi Nagashima *(Deals)*
Tel: +81 80 41775634
E-mail: takeshi.t.nagashima@jp.pwc.com

Ryuji Sawada *(Consulting)*
Tel: +81 80 96455897
E-mail: ryuji.sawada@jp.pwc.com

Assurance

Hideo Ohta
Tel: +81 80 32546831
E-mail: hideo.ohta@jp.pwc.com

Declan Byrne
Tel: +81 80 34936617
E-mail: declan.d.byrne@jp.pwc.com

Tax

Yuka Matsuda
Tel: +81 3 52512556
E-mail: yuka.matsuda@jp.pwc.com

Raymond Kahn
Tel: +81 3 52512909
E-mail: raymond.a.kahn@jp.pwc.com

Hiroshi Takagi
Tel: +81 3 52512788
E-mail: hiroshi.takagi@jp.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Luxembourg

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Luxembourg 3

Real Estate Investments – Luxembourg 9

Contacts 43

All information used in this content, unless otherwise stated, is up to date as of 25 April 2016.

Real Estate Tax Summary – Luxembourg

General Overview

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 2016, range from 0% up to 40%. A 7% or 9% surcharge for contribution to the unemployment fund applies on the income tax due.

In the context of a large tax reform planned for 2017, the income tax brackets for individuals will be revised. The personal tax rates for individuals earning more than €150,000 would amount to 41% respectively 42% for income exceeding €200,004.

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 22.47% in fiscal year 2016 (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.

On 29 February 2016, the Luxembourg Finance Minister announced changes to the Luxembourg corporate tax system planned for 2017. The change include, notably, a reduction of the corporate income tax rate from 21% to 18% (in two steps).

Before 1 January 2016, Luxembourg imposed two types of minimum corporate income tax charges. Luxembourg has now repealed the minimum corporate income tax charge and modified the Net Wealth Tax regime ("NWT").

As of 1 January 2016, Luxembourg levies a minimum NWT charge for all corporate entities having their statutory seat or central administration in Luxembourg. Entities whose sum of their financial assets, transferable securities and cash at bank exceeds 90% of their total gross assets and €350,000 are subject to a minimum NWT charge of €3,210. 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.

Similar to the previous minimum corporate income tax regime, 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 if 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 1 January of each financial year. As of 1 January 2016, 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 EU Savings Directive which exceptionally applied a withholding tax is no longer applicable as it has been repealed on the 10 November 2015. Instead Luxembourg have implemented the Foreign Account Tax Compliance Act (FATCA) an intergovernmental agreement between the USA and 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 automatic exchange of information 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 financial institutions 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 AOI 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, or
  - a company resident in a member state of the European Union 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'), or
  - a Luxembourg permanent establishment of a company resident in a member state of the European Union and falling under article 2 of the foregoing Directive, or
  - 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 10.5% 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 new European General Anti-Avoidance provision, amending the participation exemption regime under the Parent Subsidiary Directive, has been effectively incorporated into Luxembourg law. The new 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. The new rule is effective for income allocated after 31 December 2015.

According to this new 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 28 January 2011 and 8 April 2011, the Luxembourg tax authorities issued two Circulars concerning the tax treatment of Luxembourg entities that are mainly engaged in intra-group lending activities financed by borrowings. These guidelines are aimed at assisting the tax authorities and companies dealing with intra-group financing to determine their taxable result in Luxembourg in accordance with OECD transfer pricing principles. The Circular expressly requires that a Luxembourg entity engaged in financial intermediation activity should maintain an adequate level of equity and real operational substance, with regard to the functions performed, if it wishes to secure by a confirmation from the Luxembourg tax authorities that its arrangements are seen as satisfying the 'arm's length' principles.

Under the new transfer pricing rules that were introduced with effect from January 2015, Luxembourg Income Tax Law is now aligned with the OECD Tax Model Convention and as a result of this new transfer pricing legislation the Luxembourg tax payer is obliged to report either up or downward adjustments in the tax returns where transfer prices do not reflect the arm's length principle.

The new provision applies only to transactions between related parties both located in Luxembourg as well as where one party is tax resident in a foreign jurisdiction.

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.

Supplies of services – place of taxation

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 – place of taxation

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 (droit d'enregistrement)

Transactions involving the transfer of immovable property are subject to registration duty 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. The rates of registration duties are either fixed or proportional and can be significant. Further details are set out below.

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).

Real Estate Investments – *Luxembourg*

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 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.

This summary comprises general background information on legal and taxation aspects of the most common real estate types of investment made in or through Luxembourg.

Direct investment in Luxembourg 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 (droit d'emphytéose)

A long lease 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 (droit de superficie)

A building right 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, ie, private individual resident or non-resident taxpayer, the taxable basis of income derived from the property will be determined in accordance with Luxembourg law.

For individual resident taxpayers in Luxembourg, an additional contribution called ***'assurance dépendance'*** (1.4%) is due on income derived from property.

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 either the income from the actual rental of a building, or the rental value (*valeur locative*) of a building occupied by an owner-occupier.

However, only the net amount of rental income derived from the property investment is subject to Luxembourg income tax.

Determination of the net rental income derived from the actual rental

The net income is equal to the 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.

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.

According to the draft bill regarding the 2016 tax reform, it is planned that income arising from the rental of housing to approved social organisations (eg, *Agence Immobilière Sociale*) will benefit from a 50% exemption.

Determination of the net rental income derived from the owner-occupier

A fictitious rental income is calculated on the basis of the real estate assessed unitary value as determined and communicated by the Luxembourg tax authorities.
The fictitious rental income equals to 4% of the assessed unitary value not exceeding €3,800 and to 6% of the assessed u**nitary value above €3,800.**

The rental value of the occupier's principal dwelling can only be reduced by interest paid on loan financing the acquisition of the property or the construction

of an extension to the property. The maximum amount of interest that can be deducted is set by grand-ducal regulation. For 2016, ceilings are fixed at €1,500 per annum per family member for the first year of occupation and the five following years. This amount falls to €1,125 for the next five years of occupation, then to €750 for the following years.

The ceilings for the mortgage interest deductions related to the main residence will be revised in the context of the 2016 tax reform. The amounts will likely increase as follows: €2,000 (instead of €1,500) for the first year of occupation and the following five years, €1,500 (instead of €1,250) for the subsequent five years and €1,000 (instead of €750) for the following years.

However, given that the unitary value of the building is generally very low, the fictitious rental income is usually negative and creates a loss, which can be offset against other taxable income.

The tax rate for rental income is the recipient's marginal tax rate, which varies between 0% and 40% for 2016 (to which the surcharge for the unemployment fund contribution is added), depending on the taxpayer's overall level of income.

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 50% of the marginal tax rate (maximum 21.8% for 2016).

According to the latest draft of the 2016 tax reform, capital gains arising from the disposal of real estate (other than capital gains on the sale of a main residence, which is fully exempt) will likely be taxable at ¼ of the taxpayer's overall effective tax rate. This measure applies, if the sale occurs during the period from 1 July 2016 to 31 December 2017.

Under specific conditions, taxation of the capital gains resulting from the disposal of property can be deferred to the extent that these gains are used to fund the acquisition of a new property located in Luxembourg, which the owner intends to put up for rent.

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 29.22% (for Luxembourg City) for 2016.

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 so as 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. As previously mentioned, the Luxembourg Government announced their proposal to limit the use of losses generated as from 1 January 2017. Such losses would only be available to offset the taxable profits of subsequent periods up to a maximum of 75% of the taxable profits of each period. Also, losses generated after 1 January 2017 would only be able to be carried forward for a maximum period of 17 years.

Resident partnerships

SCSa and SCSps 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 Luxembourg Income Tax Law.

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 a recently issued 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

Under the Luxembourg tax law, a permanent establishment 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 permanent establishment. 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 29.22% (for Luxembourg City) for 2016.

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. (Please refer to the 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 22.47% for 2016. 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 consequences, input VAT incurred on related costs is recoverable.

The leasing or letting of immovable property is also exempt from VAT 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 '*Value-added tax*'.

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 €12,500 (or equivalent in other currency) for an S.à r.l. and €31,000 (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 (ie, more than 10% of the shares held alone or together with spouse and minor children, directly or indirectly, at any time during the five years prior to the day of disposal) in a company having its registered office or principal establishment in Luxembourg, within six months of the acquisition of the shareholding. In this case, the capital gain will be subject to tax on income at the normal rates (ie, according to progressive income tax rates with a maximum to 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 descr**ibed 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

The transfer of shares in an SCI is usually VAT-exempt.

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.

An SCI investing in real estate is subject to the same rules as other companies (see the section '*Direct investment in real estate*').

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 29.22% for 2016 (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, or
  - 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 10.5% on a taxable basis determined similarly to that in Luxembourg, or
  - a company that is resident in a member state of the European Union and covered by article 2 of the Parent-Subsidiary Directive.
- The beneficiary company is:
  - a fully taxable Luxembourg joint-stock company, or
  - a Luxembourg permanent establishment of a company that is resident in a member state of the European Union 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 new European General Anti-Avoidance provision, amending the participation exemption regime, has effectively been incorporated into Luxembourg law. The new 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. The new rule is effective for income allocated after 31 December 2015.

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 this new 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 29.22% 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 10.5% on a taxable basis determined similarly to that in the Luxembourg, or a company that is resident in a member state of the European Union and falling under article 2 of the Parent-Subsidiary Directive.
- The beneficiary is:
  - a fully taxable Luxembourg joint-stock company, or
  - a local permanent establishment of a company that is resident in a member state of the European Union 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.

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.

- 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.

Indirect taxes

The transfer of shares is usually VAT-exempt.

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.

Investment in a foreign property by a Luxembourg company

Luxembourg companies are also frequently used to invest directly into real estate located abroad (eg, in the United Kingdom or in Germany).

Luxembourg companies are in principle subject to corporate income tax and municipal business tax on their worldwide income at the aggregate rate of 29.22% 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.

Real estate investment vehicles

Luxembourg offers a wide range of regulated and non-regulated fund vehicles that can usually meet the different requirements of real estate fund promoters and managers readily.

Choosing one real estate fund vehicle over another will mainly depend on the type of funding that needs to be raised, the type of investors targeted, the flexibility sought in terms of running the fund, and specific investor tax considerations. In particular, the Luxembourg tax regime is a key factor when considering the choice of an unregulated or a regulated real estate investment vehicle for international investors.

The tax regime applicable to unregulated holding companies owing real estate owning subsidiaries has already been described in the section *'Investment in a property company by a holding company'*. It is however noted that this type of holding and financing company is extremely popular with fund managers and promoters globally, who are seeking a tax regime that has attributes that favour a 'platform' for managing investments into a geographic region rather than a single territory for investment. Luxembourg is for this reason, the holding and financing location of choice, in particular for pan-European and Asian real estate funds, even when the fund vehicle itself is not set up in Luxembourg.

The Directive 2011/61/EU of 08 June 2011 (the Alternative Investment Fund Manager Directive or "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 of 17 December 2010 on Undertakings for Collective Investment (the "2010 Law"), as amended, or the law of 13 February 2007 relating to Specialised Investment Funds, as amended (the "SIF Law"), or the upcoming provisions of Bill 6929 of 14 December 2015 introducing the Reserved Alternative Investment Fund (the "RAIF"), which is expected to be enacted in Q2 2016.

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.

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*, SCSp) without legal personality was introduced, as well as the legal framework of the existing Luxembourg limited partnership (*Société en commandite simple*, SCS), which has legal personality, has been modernised. Both the Investment Company in Risk Capital (SICAR) and Specialised Investment Funds (SIF) may adopt the form of an SCS/SCSp.

Open-ended versus closed-ended investment funds

FCPs, SICAFs and SICAVs may operate as open-ended or closed-ended funds:

- Open-ended investment funds have rules that allow investors to request that the fund repurchases their units each time redemptions are possible according to the prospectus;

- By contrast, closed-ended investment funds may not, at the request of investors, repurchase their shares or units; the fund governing bodies decide when redemptions are possible.

Sub-funds and classes of shares

Investment funds can have various sub-funds (the terminology used is that of 'umbrella fund'), each with a different investment policy or restricted to certain investors. The principle of segregation applies, meaning that each sub-fund is treated as a separate entity where the assets of one sub-fund cannot be used to settle the liabilities of another sub-fund.

Investment funds can further issue several classes of shares (however with no segregation between the classes of shares) with different fee levels, different minimum subscription amounts, different investor profiles (institutional/retail), different income policy (distributing or capitalising shares), different currencies, etc.

Regulatory aspects for the UCIs

The main features of Part II UCIs (being UCIs subject to Part II of the 2010 Law) are summarised as follows:

Common rules applicable to all Part II UCIs

Legal forms available	• Investment company with variable capital (SICAV); • Investment company with fixed capital (SICAF) • Contractual fund (FCP)
Eligible investors	No restriction on the type of investors authorised to invest in a Part II UCI
Licensing requirements	**Part II UCIs must receive the CSSF's prior** authorisation 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 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 • 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

Definition of eligible real estate assets	Land and/or buildings registered in the name of the UCI Shareholdings in real estate companies (including debt securities of such companies), ie, companies whose exclusive object and purpose is the acquisition, promotion and sale, as well as the letting and agricultural lease of property, provided that these shareholdings must be at least as liquid as the property

	rights held directly by the UCI. Property-related long term interests, eg, surface ownership, lease-holds, and option rights on real estate.
Maximum investment in one property	Maximum 20% of fund/sub-fund's net assets in a single property; Property whose economic viability is linked to another property is not considered a separate item of property; This restriction (i) is not applicable during the start-up phase of the fund, which may not extend beyond a four-year period following the closing date of the initial offer period and (ii) is to be considered at the date of acquisition of the real estate property.
Maximum leverage	Borrowings may not exceed 50% of the valuation of all properties in the fund.
Minimum liquid assets in the fund	No minimum foreseen by regulation but the fund's liquidity features must be in line with sections dealing with investors' ability to redeem as per the prospectus.
Minimum frequency of NAV calculation	Once a year and each time shares or units are issued to, or redeemed from, investors. Management may use the valuation established at the year-end throughout the following year unless there is a change in the general economic situation or in the condition of the properties which requires new valuations to be carried out under the same methods as those used for the annual valuation.
Requirement for independent valuation of the properties	Yes, at least annually and each time properties are bought or sold. Valuation to be performed by recognised professionals in the Real Estate sector.
Borrowings	May not exceed on average 50% of the assets

Regulatory aspects for SIFs and RAIFs	
Legal forms available	• Investment company with variable capital (SICAV) to be incorporated as a public limited company (S.A.), a private limited company (S.à r.l.), a cooperative company organised as a public limited company (SCoopSA), as a corporate partnership limited by shares (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 CSSF prior authorisation before it can start its activities. The CSSF will pay particular attention to: • The fund's draft constitutional and offering documents; • The identity of the investment manager of the fund which must be duly licensed for that function in its country of domicile; • The identity of the persons in charge of conducting the business of the fund; they must show good reputation and adequate experience for acting in such capacity; • The identity of the Luxembourg central administration, the Luxembourg depositary and the Luxembourg external auditors. SIFs are required to inform the CSSF and comply with specific requirements in case of delegation of functions. Moreover, SIFs must implement an appropriate system of risk management and must be structured and organised in a manner to reduce to a minimum the conflicts of interest A RAIF will not be subject to any authorisation or direct supervision from the CSSF. The RAIF shall also benefit from an exemption from CSSF's authorisation for its set-up and for the supervision regarding ongoing amendments to offering documents during the life of the fund, being the fund only indirectly supervised through its AIFM.
Compulsory service providers in Luxembourg	• Depositary: responsible for safekeeping the SIF/RAIF assets – must be a Luxemburg bank or Luxembourg branch of a foreign bank • Central administrator: responsible for accounting, NAV calculation, keeping of the register of the shareholders/unit holders, handling subscriptions and redemptions, communication with investors and preparation of financial statements – which must be a Luxembourg bank or a branch of a foreign bank or a professional of the financial sector with a proper license • A Chapter 16 Management Company or an AIFM if the fund is set up as an FCP • 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 twelve 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	Yes, 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 for an amount over €10,000) received from foreign suppliers.

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 described above applies to this type of vehicles.

The management of regulated investment vehicles as well as AIFs is explicitly 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	
Eligible investors	Well-informed investors
Legal forms available	• Public limited company (S.A.); • Private limited company (S.à r.l.); • Corporate partnership limited by shares (SCA); • Limited partnership (SCS); • Special limited partnership (SCSp); • Cooperative company organised as a public limited company (SCoopSA).
Licensing requirements	SICARs must receive the CSSF's prior authorisation before they can start their activities. The managers, the auditor and the custodian are also subject to the CSSF's pre-approval, but there is no such requirement for the promoter and the investment manager of the SICAR. In addition, the CSSF requires, inter alia, a business plan with a risk analysis, as well as a description of the governance structure.
Minimum capital requirement	Subscribed share capital including share premiums must reach €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.
Compulsory service providers in Luxembourg	Depositary: responsible for safekeeping the SICAR assets, must be a Luxembourg bank or a Luxembourg branch of a EU bank Central administration: must be a Luxembourg bank or a Luxembourg branch of a EU bank or a professional of the financial sector with a proper license External auditor.
Minimum frequency of NAV calculation	Once a year

A key element of a SICAR is that it can create multiple investment compartments and can issue different classes of shares, in the same way as investment funds.

Particular tax implications

Taxation of the SICAR entity

The applicable taxation regime depends on the legal form of the SICAR. The SICAR in the form of a limited partnership (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.

As from 1 January 2016 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 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 for an amount over €10,000) received from foreign suppliers.

In practice, SICARs which have their own human and technical means to perform independently an economic activity subject to VAT may however be derogated from the above general rule.

The service of management of SICARs is explicitly exempt from VAT in Luxembourg.

Real Estate securitisation structures

Regulatory aspects of securitisation structures

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 securisation 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 de**nominations 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, ie, 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.

As per 1 January 2016 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 for an amount over €10,000) received from foreign suppliers.

In practice, it can happen that securitisation vehicles perform independently an economic activity subject to VAT. In that case, the securitisation vehicles may be derogated from the above general rule.

The management of Luxembourg securitisation vehicles is exempt from VAT in Luxembourg.

Real Estate leasing contracts

General aspects

Leasing companies are not considered as credit institutions, insofar as they do not collect deposits or funds from the public.

Consequently, leasing companies in principle do not need a licence from the Luxembourg Central Bank (LCB) for carrying out their activity, nor do they fall under the supervision of the LCB. However, they will have to file a specific request to exercise this activity with the Ministry of Small Businesses (*Ministère des Classes Moyennes*). Some exceptions may apply within the framework of intra-group transactions.

Legal framework

The law does not contain a definition of a lease contract. All lease contracts are basically treated as rental agreements under article 1710 of the Civil Code. The lessor conveys to the lessee, in return for rent, the right to use an item of property for an agreed period of time. At the expiration of the period, the contract may offer the lessee the opportunity to acquire the leased asset.

This is confirmed by several Luxembourg Supreme Court decisions. A decision of the Court in 1977 provided the following analysis of the legal nature of a leasing contract under commercial and civil law.

It is important to stress that, from an economic and financial point of view, a leasing/credit operation can be described as follows: a specialised financing company acts on behalf of entrepreneurs who are looking for equipment without the necessity of having to bear the initial price of acquisition. The entrepreneur makes the choice of the equipment needed; the leasing company substitutes itself for him in buying the equipment and renting it to the entrepreneur. The leasing agreement is concluded for a term sufficient for the lessor-owner to recover the value of the leased asset. The leasing agreement distinguishes two periods: the primary period, called the irrevocable period, which has a duration close to the tax depreciation period;

and the second period, the residual period, which continues until the extinction of the economic life of the equipment.

At the expiration of the first period, the entrepreneur-lessee is granted an option either to return the equipment to the lessor-owner or to acquire the asset at its minimum residual value or to go on with the leasing at reduced rentals in respect of the residual value.

Categories of leasing contracts

Financial leasing contracts

A financial leasing is a full-payout leasing contract, ie, the lease payments payable to the lessor during the irrevocable term cover the acquisition and manufacturing costs of the asset and all incidental expenses, including the lessor's financing costs.

Operating leasing contracts

An operating leasing is considered as an ordinary rental agreement, with the following characteristics:

- In general, the agreement may be cancelled at any time.
- The risk of an increase or decrease in value for economic or technical reasons, insurance premiums, and the repair and maintenance costs of the asset are mainly borne by the lessor.

Non-full-payout leasing contract

A non-full-payout contract can be cancelled after a predetermined period. The leasing payments made during the lease term only cover a part of the purchase price and all incidental expenses and the lessor's financing costs.

Attributes of the leased assets

Legal ownership

The law does not provide a definition of a lease contract. All lease contracts are basically treated as rental agreements under article 1710 of the Civil Law, ie, the lessor conveys to the lessee the right to use an item of property for an agreed period of time in return for rent

Economic ownership

The economic ownership of the asset is attributed to the lessor or the lessee depending on the terms of the contract. From an accounting and tax viewpoint, economic ownership is the relevant element in determining whether the real estate is attributed to the lessee or the lessor. The attribution of economic ownership is based on German case law.

Particular tax implications

One of the key principles of Luxembourg tax law is that it follows the accounting rules, unless tax law provides for other rules. Regarding leasing contracts, as no specific accounting rules exist in Luxembourg, tax law is usually followed for accounting purposes, and therefore the attribution of the subjects of the leasing as referred to above is of prime importance.

Corporate income tax

Asset attributed to the lessor

The lessor capitalises the leased asset as a fixed asset in its balance sheet and depreciates it according to its economic lifetime. The annual lease payments are treated as taxable profit to be booked in its profit and loss account.

The leasing payments are treated as operating expenses, which are tax deductible, in **the lessee's profit and loss account.**

Asset attributed to the lessee

From the lessor's point of view

The lessor records the minimum leasing payments in its balance sheet as a receivable (ie, the payments over the leasing term that the lessee is or can be required to make, without the costs for services and taxes to be paid by and reimbursable to the lessor). The annual leasing payments are broken down into a refund of capital and an interest component. The interest will be treated as taxable **profit in the lessee's profit and loss** account.

From the lessee's point of view

First, the lessee capitalises and depreciates the leased asset in its balance sheet. Then, it records a corresponding liability for the future leasing payments. The leasing payments have to be apportioned into an interest and a capital portion. The interest portion is treated as an operational expense in the profit and loss account of the lessee. The capital portion will reduce the liability.

Municipal business tax

There is no particular tax treatment for municipal business tax.

Net wealth tax

Asset attributed to the lessor

The lessor has to add the unitary value of the leased building to its net wealth taxable basis. Until the lessee exercises any call option stipulated in the leasing contract, the lessor has to report the unitary value of the leased building in its net wealth taxable basis.

Asset attributed to the lessee

The lessee has to add the unitary value of the leased building to its net wealth taxable basis. It can deduct from this taxable basis the lease payments not yet paid at the time the unitary value is fixed. This deduction includes the amount related to any call option to be exercised at the end of the primary leasing period.

The lessor has to include in its own net wealth taxable basis an amount corresponding to the leasing payments not yet paid.

VAT

As a general rule, the leasing of an existing property located in Luxembourg is exempt from Luxembourg VAT. Accordingly, the landlord is not entitled to recover input VAT incurred on related expenses.

The landlord may however opt to VAT to the extent that the option conditions are met. In consequence, input VAT incurred on related expenses is recoverable.

Registration duty

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 (ie, if a valid option is obtained).

Leases not subject to VAT are in principle subject to a registration duty of 0.6%. The taxable amount is the aggregate amount of the rental fees over the term of the lease.

Contacts

Advisory

Nicolas Schulz
Tel: +352 49 48 48 4211
E-mail: nicolas.schulz@lu.pwc.com

John Ravoisin
Tel: +352 49 48 48 5456
E-mail: john.ravoisin@lu.pwc.com

Assurance

Amaury Evrard
Tel: +352 49 48 48 2106
E-mail: amaury.evrard@lu.pwc.com

Kees Hage
Tel: +352 49 48 48 2059
E-mail: kees.hage@lu.pwc.com

Tax

Alexandre Jaumotte
Tel: +352 49 48 48 5380
E-mail: alexandre.jaumotte@lu.pwc.com

Thierry Braem
Tel: +352 49 48 48 5106
E-mail: thierry.braem@lu.pwc.com

Marie-Isabelle Richardin
Tel: +352 49 48 48 3009
E-mail: marie-isabelle.richardin@lu.pwc.com

Fabienne Moquet
Tel: +352 49 48 48 3179
E-mail: fabienne.moquet@lu.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
Malaysia

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Malaysia 3

Contacts 16

All information used in this content, unless otherwise stated, is up to date as of 31 March 2016.

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 Foreign Investment Committee (FIC) 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 property trusts.

In line with the 2014 Budget, the Guideline on the Acquisition of Properties issued by the FIC has been revised effective 1 March 2014.

Based on the relaxed FIC guidelines, a foreign interest is not allowed to acquire:

- properties valued less than 1m MYR per unit
- residential units under the category of low and medium low cost as determined by the State Authority
- properties built on Malay reserve land
- properties allocated to *Bumiputera* interest in any property development project as determined by the State Authority.

The government had announced that the FIC approval will only be required for the following situations:

- Direct acquisitions of property valued at 20m MYR and above, resulting in the dilution of *Bumiputera* interests in the property.
- Direct acquisitions of property valued at 20m MYR and above, resulting in the dilution of government agency in the property.
- Indirect acquisitions of property by other than *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 20m MYR.

The following property transactions will no longer require FIC approval, but fall under the purview of the relevant ministries or government departments:

- Foreigners are allowed to purchase residential units valued at more than 1m MYR but falls under the purview of the State Authorities. No conditions will be imposed on the usage of the properties or number of units owned.
- Foreign interests are only allowed to acquire agricultural land valued at more than 1m MYR or at least five acres in area for the following purposes and must be

registered under a locally incorporated company and subject to prescribed conditions:

- to undertake agricultural activities on a commercial scale using modern or high technology; or
- to undertake agro-tourism projects; or
- to undertake agricultural or agro-based industrial activities for the production of goods for export.

- Foreign interests are allowed to purchase industrial land or commercial units valued at more than 1m MYR and must be registered under a locally incorporated company and subject to prescribed conditions.
- Transfer of property to a foreigner based on family ties is only allowed among immediate family members.

Acquisitions of properties by licensed manufacturing companies are exempted from requiring the approval of FIC.

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. In general, where an acquisition of assets by foreign interests is made through a locally incorporated company, the permitted foreign equity in the local company is up to a maximum of 70%.

Real estate investment trust (REIT)/Property trust fund (PTF)

The SC issued new guidelines on REITs on 21 August 2008 (which was subsequently updated on28 December 2012) to accelerate growth and establish a vibrant and competitive real estate investment trust industry in Malaysia. The new guidelines supersede the earlier Guidelines on Real Estate Investment Trusts issued on 3 January 2005, Guidelines on Property Trust Funds issued on 13 November 2002, and all guidance notes and circulars issued following those guidelines.

In addition, the Inland Revenue Board of Malaysia (MIRB) has issued Public Rulings in relation to REIT/PFTsto replace the Guidelines on Real Estate Investment Trusts or Property Trust Funds (REITs/PTF) dated 29 June 2005. They are:

- **Public Ruling No. 2/2015 'Taxation of Real Estate Investment Trust or Property Trust Fund'**Public Ruling N**o.8/2012 'Real Estate Investment Trusts/Property Trust** Funds – An **Overview'**
- **Public Ruling No.9/2012 'Taxation of Real Estate Investment Trusts/Property Trust Funds'**

Malaysian REIT/PTFs 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 REIT/PTFs 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 unitized. 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 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/PTF. 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
  - any other institution which the SC may permit.
- have a minimum of 30% local equity
- have minimum shareholders' funds of 1m MYR at all times.

The initial minimum size of a REIT/PTF should be at least 100m MYR. A REIT/PTF 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/PTF 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.

Exchange control rules

Subject to the FIC guidelines, a non-resident is free to obtain any amount of Ringgit borrowings from licensed onshore banks (excluding licensed international Islamic banks) to finance activities in the real estate sector in Malaysia, or finance/refinance the purchase of residential and commercial properties in the Malaysia, except for the purchase of land only.

Effective 3 December 2014, the following relaxations have also been accorded to resident companies wishing to obtain financing:

Foreign currency borrowings

A resident company is free to borrow any amount in foreign currency from:

- resident or non-resident direct shareholders
- resident or non-resident entities within its group of entities
- licensed onshore banks[1]
- another resident through the issuance of foreign currency debt securities

A prudential limit of RM 100m 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.

Foreign currency borrowing by resident individuals from licensed onshore banks and non-residents, other than immediate family members, is subject to an aggregate limit of RM 10m equivalent.

Ringgit borrowings

A resident company is allowed to borrow in ringgit:

- of any amount from its non-resident entities within its group of entities and their non-resident direct shareholders to finance activities in the real sector[2] in Malaysia
- up to 1m 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 25% (24% w.e.f YA 2016) unless specific exemptions apply.

Rental income derived from properties situated in Malaysia is subject to income tax, and may be taxed as business income or investment income, depending on the circumstances in each case.

---

[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.

The MIRB issued a revised public ruling on 10 March 2011 setting out the criteria for rental income to be treated as business income.

Letting of real property is deemed as a business source if maintenance services or support services are comprehensively and actively provided in relation to the real property.

Maintenance services or support services comprehensively provided refers to services including:

- doing generally all things necessary (eg, cleaning services or repairs) for the maintenance and management of the real property such as the structural elements of the building, stairways, fire escapes, entrances and exits, lobbies, corridors, lifts/escalators, compounds, drains, water tanks, sewers, pipes, wires, cables or other fixtures and fittings; and

- doing generally all things necessary for the maintenance and management of the exterior parts of the real property such as playing fields, recreational areas, driveways, car parks, open spaces, landscape areas, walls and fences, exterior lighting or other external fixtures and fittings; or

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 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.

---

[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/PTF

With effect from year of assessment 2005, rental income from the letting of real property received by REIT/PTF is to be treated as business income. The undistributed income of the REIT/PTF will be subject to normal corporate income tax, currently at 25% (24% w.e.f YA 2016). Due to new tax transparency legislation, distributed income by REIT/PTF will not be taxed at REIT/PTF level, provided that the REIT/PTF distributes 90% of its income. Instead, the unitholders will be taxed on such distributions received.

Where a REIT/PTF intends to distribute 90% or more of its total income but has fallen short of 90% at the end of the basis period, the REIT/PTF 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/PTF level.

Tax-deductible expenses are those revenue expenses wholly and exclusively incurred in **the production of income and normally includes the REIT/PTF 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.

Effective year of assessment 2006, fees for consultancy, legal and valuation services incurred in the establishment of REIT/PTF will also be allowed as a tax deduction.

Where the property has not begun to produce rental income, no deductions will be allowed.

Pursuant to the Public Ruling No. 2/2015 **'Taxation of Real Estate Investment Trusts/Property Trust Funds',** the rental source for a building is considered to have commenced if the building is available for rent. Hence any related expenses incurred prior to the commencement of that source of income are not deductible against the rental income of a REIT / PTF. This is not consistent with the tax legislation. However to-date, the MIRB has not issued any formal position on this issue.

Depreciation and capital allowance for industrial buildings

Depreciation of land and buildings does not qualify for tax deduction against rental income, and capital allowances are not available for residential and commercial buildings.

Where a building is classified as an industrial building (eg, factory, warehouse, etc), and it is used for business or leased to a tenant who uses the premise as an industrial building, a capital allowance known as an industrial building allowance (IBA) can be claimed against the business or rental income of the owner of the building. 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.

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[4]	80%
• Security control equipment and monitoring equipment[5]	80%
• Motor Vehicle (private passenger car type)[6]	20%

Accelerated capital allowances are eligible for certain plant and equipment.

Expenditure on assets with life span of not more than 2 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/PTF, 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

---

[4] The accelerated capital allowance (ACA) for computer and information technology assets are not available to a company where during that basis period the company is eligible and has claimed in respect of that ICT equipment:
a) investment tax allowance under the Promotion of Investments Act 1986 [Act 327]
b) reinvestment allowance under Schedule 7A to the Income Tax Act, 1967 (ITA)
c) investment allowance for service sector under Schedule 7B to the ITA
d) tax exemption under any order made under Section 127 of the ITA in respect of his statutory income which is equivalent to any part of the whole of the amount if the qualifying capital expenditure incurred by the company
These rules are effective for Year of Assessment (YA) 2009 to YA 2013, and has been extended to YA 2016.

[5] The ACA for security control equipment and monitoring equipment are not available to a company in the basis period for a YA if a company has been granted tax incentives under:
a) the Promotion of Investments Act 1986 [Act 327]
b) reinvestment allowance under Schedule 7A to the ITA
c) any exemption under Section 127 of the ITA
d) an allowance at a higher fraction under the ITA or any rules made under Section 154 of the ITA

[6] 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

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 with effect from 1 January 2014:

Date of disposal	RPGT rates (%)		
	Companies	Individual (citizen & permanent resident)	Individual (non-citizen)
Within 3 years from date of acquisition	30	30	30
In the 4th year	20	20	30
In the 5th year	15	15	30
In the 6th year and subsequent years	5	Exempt	5

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/PTF approved by the SC, exemptions from RPGT and stamp duty have been provided for. This exemption applies only to acquisitions of properties by an approved REIT/PTF. Where the approved REIT/PTF subsequently sells properties, the RPGT and stamp duty exemption would not apply.

Dividends

A new single-tier system was introduced effective year of assessment 2008 to replace the previous tax imputation system whereby tax is levied on the profits of the company as a final tax. Dividends subsequently received by the shareholders are exempted from tax.

A transitional period has also been introduced, whereby companies under the tax imputation system which has unutilised Section 108 balances as of 31 December 2007, are given a six-year period (from 1 January 2008 to 31 December 2013) to use the Section 108 credits for payment of franked dividends. The savings and transitional provisions also prohibit the claiming of tax credits by shareholders during the transitional period in the following circumstances:

- The receipt of dividends from shares that are not held continuously for 90 days or more from the date of purchase of shares (exclude shares in public listed companies); or
- The receipt of non-cash dividend; or
- The receipt of dividends that relate to non-ordinary shares[7]

The single-tier system is fully applicable for all companies from 1 January 2014 and all dividends distributed by a resident company are not subject to tax in Malaysia.

Taxation of REIT/PTF

The income of a REIT/PTF, consisting of rental, interest (other than interest which is exempt from income tax) and other investment income derived from or accruing in Malaysia (after deducting tax allowable expenses), will be taxable at the normal corporate tax rate (currently at 25% (24% w.e.f YA 2016)).

The tax transparency system however, exempts the REIT/PTF from such taxes in a year of assessment if the REIT/PTF distributes at least 90% of its total taxable income in the same year of assessment.

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/PTF would continue to be taxed, currently at the prevailing rate of25% (24% w.e.f YA 2016). Income which has been taxed at the REIT/PTF level will have tax credits attached when subsequently distributed to unitholders.

With the introduction of the single-tier system effective 1 January 2008 which is fully applicable for all companies from 1 January 2014, all dividend income received by the REIT/PTF from a resident company are not subject to tax in Malaysia.

Exempt Income

Since the REIT/PTF 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;
- debentures or Islamic securities, other than convertible loan stocks, approved by the Securities Commission;
- *Bon Simpanan Malaysia* issued by Bank Negara Malaysia; and
- bonds and securities issued by *Pengurusan Danaharta Nasional Berhad*.

[7] Section 40(3) ITA: Ordinary shareholding means holding of shares other than shares that carry only a right to any dividend that is of a fixed amount or at a fixed rate per cent of nominal value of the shares, or a fixed rate per cent of the profits of the company.

Interest paid or credited by any bank or financial institution licensed under the Banking and Financial Institutions Act 1989 or the Islamic Banking Act 1983 is tax exempt. Income received by the REIT/PTF from overseas investment is also tax exempt. The income exempted at the REIT/PTF level is also exempt from tax upon distribution to unitholders.

Foreign sourced income earned by the REIT/PTF is generally not taxable in Malaysia. Foreign source income is only taxed in Malaysia where the recipient is a financial institution or seen to be dealing in investments. Foreign sourced income earned by the REIT/PTF will retain its character when distributed to its unitholders so that no withholding tax will apply.

Taxation of REIT/PTF 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/PTF has distributed 90% or more of its total taxable income.

The REIT/PTF distributes 90% or more of taxable income

Where 90% or more of the REIT/PTF's total taxable income is distributed by the REIT/PTF, distributions to unitholders will be subject to tax based on a withholding tax mechanism at the following rates:

Unitholders	Withholding tax rate
Individuals and all other non-corporate investors such as institutional investors[8] (resident and non-resident)	10%[9]
Non-resident corporate investors[10]	25% (24% w.e.f YA2016)
Resident corporate investors	0%[11]

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 REIT/PTF 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 REIT/PTFs in their normal corporate tax return and bring the taxable REIT/PTF distributions at the normal corporate tax rate, currently at 25% (24% w.e.f YA2016).

[8] Institutional investor means a pension fund, collective investment scheme or such other person approved by the Minister of Finance.
[9] This reduced rate of withholding tax is effective from 1 January 2012 to 31 December 2016.
[10] Company means an incorporated body.
[11] Corporate unitholders who are tax resident in Malaysia would have to file tax returns and declare such REIT/PTF income which is taxed at 25% (24% w.e.f YA 2016).

The REIT/PTF distributes less than 90% of taxable income

Where less than 90% of the total taxable income is distributed, the REIT/PTF is not entitled to the exemption. The REIT/PTF would have paid taxes on the taxable income for the year. The distributions made by the REIT/PTF 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/PTF.

Resident corporate investors

Resident corporate investors are required to report the distributions from REIT/PTFs in their normal corporate tax return and bring such income to tax at the normal corporate tax rate, currently 25% (24% w.e.f YA 2016). Where tax has been levied at the REIT/PTF 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.**

Distributions representing specific exempt income or gains on disposal of investments at the REIT/PTF 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/PTF, 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/PTF 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/PTF 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 thin capitalisation rules

The tax authorities have issued the Transfer Pricing Guidelines since 2003 wherein all **transactions between related parties are required to be conducted on an arm's** length basis. Under this principle, the conditions made or imposed between two related parties in their commercial or financial transactions must not differ from those that would be made between independent parties engaging in similar transactions under similar circumstances.

Section 140A of the Act came into effect from 1 January 2009. The salient point of Section 140A is that transactions with associated persons for acquisition or supply of **property or services must be at an arm's length price. If the Director General has** reason to believe that the transaction price is too low or too excessive, the Director General is empowered to make adjustments on transactions of goods, services or **financial assistance carried out between related companies based on the arm's length** principle as well as prescribe thin capitalisation rules which seek to restrict tax deduction on excessive interest, finance charges, other consideration paid or payable or losses suffered on financial assistance granted by associated person. However, the implementation of the thin capitalisation provision has been deferred until 31 December 2017. The Ministry of Finance has informed that the rules will take effect from 1 January 2018.

In addition to this, the Income Tax (Transfer Pricing) Rules 2012 (in relation to Section 140A of the Act) and Income Tax (Advance Pricing Arrangement) Rules 2012 (in relation to Section 138C of the Act) were introduced on 11 May 2012, with retrospective effect from 1 January 2009. One of the key features in the new Transfer Pricing Rules is the requirement for taxpayers 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 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 discovered during the transfer pricing audit, a penalty will be imposed under subsection 113(2) or paragraph 44B (7)(b). However, a concessionary penalty rate may be imposed in a case where a voluntary disclosure was made.

In view of the above, any payment made to a related entity will need to take into consideration the above-mentioned requirements and compliance with the arm's length standard.

Other relevant taxes

Stamp Duty

Stamp duty is imposed on a wide range of documents. 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.

Effective 13 September 2003, instruments of transfer of real property by any person to a REIT/PTF approved by the SC will be exempted from stamp duty. The sale of property by the REIT/PTF is not exempt, and the purchaser has to pay the stamp duty.

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.

Contacts

Advisory

Datuk Mohd Anwar Yahya
Tel: +60 3 2173-1811
E-mail: mohd.anwar.yahya@my.pwc.com

Assurance

Mohammad Faiz Azmi
Tel: +60 3 2173-0867
E-mail: mohammad.faiz.azmi@my.pwc.com

Manjit Singh
Tel: +60 3 2173-0818
E-mail: manjit.singh@my.pwc.com

Tax & Legal

Jennifer Chang
Tel: +60 3 2173-1828
E-mail: jennifer.chang@my.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
Mexico

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Investments – Mexico 3

Contacts 17

All information used in this content, unless otherwise stated, is up to date as of 14 April 2016.

Real Estate Investments – Mexico

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.

General

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 that a typical Mexican real estate investment has.

Legal issues of Mexican Real Estate Investments

Types of ownership in Mexico

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. As a "real right" (in terms of Continental law system) persons or entities that have a property right over buildings and/or land may use, enjoy and dispose of such goods. Property entitles the owner the right to use such goods according to their nature and to receive the products (eg, revenues) that derive from such goods but also allows the owner to dispose of them. Property right is considered the paramount right in Mexican Law and is never superseded. Property rights are permanent and can be transferred upon the death of the right holder to his or her inheritors.

Co-Ownership

Co-ownership is another modality of property rights, through which it is possible to be a holder of a property. Co-ownership is set when the ownership of the 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 recognized by law, the trend is not to use this modality because of the great inconveniences associated with it, such as maintenance, use, decision making by the partners, etc. on the same object (ie, property or real estate).

Co-ownership rights impose limitations on co-owners when one of them intends to transfer their right: when a co-owner wants to dispose his share, the other owner has a preference right ("*derecho de tanto*") to acquire the right before any third party. The *derecho de tanto* is so forceful, that it can even make the intended transfer null.

Condominium

Condominium is a form of ownership whereby the owner has the exclusive ownership of a house, apartment, warehouse, etc., as a private unit of a building and also the co-ownership of common areas of the property in proportion to the value of the owned unit. Condominium is usually found to be convenient in Mexico because:

- no co-owners rights are granted, and therefore there are no limitations if a condominium right owner wants to alienate or burden the private unit.
- the owner of each private unit has his own public deed, confirming a property title.
- state or municipal services are individualized, 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 (Common Land “*ejidos*”; national goods and lands)

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 organized 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. Organization 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 organization 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 authorizations 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 AMPI (Mexican Association of Real Estate), 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 authorizations 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 formalize 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 formalized 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 1 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 recognized 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 5 years for structural issues, 3 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 authorizations 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:

1. Grantor/Trustor
2. Trustee
3. 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 authorized 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.

REITS type or vehicles

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 or AFORES ("*Administradoras de Fondos para el Retiro*"), who its 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 10 REITs listed in the Mexican Stock Exchange: *Fibra Uno, Fibra Hotel, Fibra Shop, Fibra Danhos, Fibra MacQuarie, Fibra Prologis, Fibra Inn, Fibra Monterrey, Fibra TErrafina* and *Fibra HD*.

Taxation of Mexican Real Estate Investments

Income tax

Rental income

Mexican taxpayers are subject to corporate income tax on their worldwide income. The tax rate is 30.

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 apply.

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, will be subject to an additional 10% withholding. However, if Mexico has a tax treaty with the country involved, the tax rate could be less or even 0% tax withholding.

Payments to related parties located in a preferred tax regime (ie, tax haven) are, in general subject to a punitive 40% withholding tax.

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' 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 begins to be used or in the following year. Taxpayers lose the right to claim a depreciation deduction if they do not do so in the corresponding 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 annual depreciation.

Nevertheless, the 2016 tax reform included a tax incentive allowing taxpayers to apply a lump-sum deduction (immediate deduction) of fixed assets, including immovable property (74% in 2016 and 57% in 2017).

Debt financing for the acquisition of real estate in Mexico

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. As it can be seen this definition is quite broad and the rule should be analysed in detail on a case by case basis.

VAT

Interest paid triggers VAT, which should be paid to the Mexican tax authorities on a self-assessment when interest is paid to a foreign resident. However, when the activities of the taxpayer are not subject to VAT (eg, sale of houses and dwellings), VAT on interest becomes a cost on the hands of the payer that should be deductible for income tax purposes.

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 sourced 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. In most cases, interest income is subject to withholding tax at the 35% rate; such withholding tax becomes payable (i) at the time the interest becomes due or (ii) at the time the interest is actually paid, whichever occurs first.

If interest is paid to a foreign registered bank that is resident in a tax treaty jurisdiction the applicable withholding tax rate should be 4.9%. Please note that a reduced income tax withholding rate may be applicable (eg, 10% - 15%) when interest is paid to a tax treaty country and specific requirements are met (eg, the interest is arm's length, the Mexican withholding agent receives a tax residency certificate from the foreign entity on a yearly basis, etc).

Deductibility of interest

Interest paid to foreign residents may be deducted for income tax purposes to the extent that the following conditions and 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 withholding tax 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 Mexican Income Tax Law ("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 nontaxable for the foreign resident as per its applicable country's tax provisions.

Inflation adjustment effect

The monetary assets and liabilities (including MXN liabilities and foreign currency such as US$) of a company are subject to an annual inflation adjustment calculation, which could result in the Mexican taxpayer having an inflationary gain or loss. The monetary liabilities generate an inflationary gain.

Foreign exchange gain/loss

For debt denominated in a foreign currency (ie, any currency other than Mexican pesos), the exchange gains and losses 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 carryforward. The only exception is the NOL derived from the disposition of shares that must be applied against gains of the same nature.

NOLs are also adjusted for inflation, and are a right specific to each taxpayer; so, they 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 some 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.

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 corporate income tax at an effective rate of 42.86%. This tax can be credited against the income tax of the given year and the following two years.

Furthermore, in 2014 the MITL introduced an additional 10% withholding 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.This withholding can be reduced 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) tracks 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 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.

Flat tax

This minimum corporate tax was repealed as of 2014.

Value-added tax (VAT)

According to the VAT Law, VAT is payable on the following activities:

- Alienation of goods
- Rendering of independent services
- Rentals
- 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 on 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 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)

An alienation of shares by a non-Mexican resident is taxable 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 Mexican real estate.

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.).

The tax is paid via withholding when the acquirer of the shares 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. However, if 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 through the corresponding tax return 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.

Mexican real estate investment trusts (REITs)

Under the MITL, the purpose of a Mexican REIT is the acquisition or construction of immovable property to be used in leasing activities. The immovable property must be held for at least four years. After such period of time the immovable property may be sold.

Upon contribution of the property, the REIT should issue the corresponding equity certificates. Investors contributing immovable property to the REIT are allowed to defer the payment of income tax on the gain from alienating such property. The tax is deferred until the date the investor sells the equity certificates, or the REIT sells the immovable property.

A REIT is required to invest at least 70% of its funds in the acquisition, leasing or sale of real estate; the remaining funds must be invested in registered government securities or in shares of certain investment entities.

The MITL grants REITs the benefit of not having to file income tax monthly advance payments. Instead, at the end of the tax year, the REIT calculates and pays the income tax related to its activities.

Mexican REITs must have at least ten non-related investors. Also, an investor may not hold more than a 20% interest in the trust.

Contacts

Advisory

Juan Manuel Ferron
Tel: +52 55 5263-6162
E-mail: jm.ferron@mx.pwc.com

Assurance

Javier Buzo
Tel: +52 55 5263-5726
E-mail: javier.buzo@mx.pwc.com

Tax & Legal

David Cuellar
Tel: +52 55 5263-5816
E-mail: david.cuellar@mx.pwc.com

Mario Alberto Rocha
Tel: +52 55 5263-8602
E-mail: mario.alberto.rocha@mx.pwc.com

Juan J. Chavez
Tel: +52 55 5263-6671
E-mail: juan.jose.chavez@mx.pwc.com

Marco Nava
Tel: + 52 55 5263-5894
E-mail: marco.nava@mx.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
New Zealand

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – New Zealand 3

Real Estate Investments – New Zealand 5

Contacts 10

All information used in this content, unless otherwise stated, is up to date as of 13 April 2016.

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 in New Zealand. An overseas person requires consent to acquire sensitive land, which is defined in Schedule 1 of the Overseas Investment Act 2005.

(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 2016-2017 tax year, which is the year ending on 31 March 2017, are as follows:

Taxable income NZD	Tax rate %
< 14,000	10.5
From 14,001 to 48,000	17.5
From 48,001 to 70,000	30.0
More than 70,000	33.0

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 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%).

Capital gains on the sale of property

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 the intention of resale.
- If the taxpayer 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 after 1 October 2015 and is sold within two 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 normal rates.

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.

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%.

Draft legislation has been introduced which proposes a residential land withholding tax (RLWT) for non-residents who sell residential property within two years of acquisition. This change is expected to be enacted later in 2016.

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.

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.

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.

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.

Rates are levied on rateable properties based on their rateable value. Basically, all lands are rateable. The definition of land is very broad and may include the right to pass utilities over land e.g. 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 i.e. 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.

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. 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. Local authorities have a certain amount of power over whether or not they impose conditions and there is a certain amount of room to negotiate on this point.

Contacts

Advisory

David Bridgman
Tel: +64 9 355-8327
E-mail: david.bridgeman@nz.pwc.com

Assurance

Sam Shuttleworth
Tel: +64 9 355-8119
E-mail: sam.shuttleworth@nz.pwc.com

Tax

Mark Russell
Tel: +64 9 355-8316
E-mail: mark.r.russell@nz.pwc.com

Teresa Kenny
Tel: +64 9 355-8559
E-mail: teresa.s.kenny@nz.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Norway

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Norway 3

Real Estate Investments – Norway 5

Contacts 15

All information used in this content, unless otherwise stated, is up to date as of 12 May 2016.

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 25% (as of income year 2016).

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 are 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 Cadburry-Schweps case).

Dividend distributions to a Norwegian parent company that do not meet the conditions above, will be subject to 25% tax on 3% of the dividends (effective tax rate of 0.75%).

Depreciation

The acquisition cost of land and sites is not depreciable for tax purposes.

Buildings/assets used for business purposes will normally be depreciable in accordance with the declining balance method. The buildings/assets are allocated to different depreciation groups based on type of asset (ie, office buildings, other buildings and technical installations), and may be depreciated annually at the maximum rate for the group in question.

Real Estate 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 into Norwegian real estate or in partnerships owning Norwegian real estate is not a limited liability, a statement from the Ministry of Finance may be required to determine who the taxpayer is, the investment vehicle or its investors for Norwegian tax purposes. (This is mainly 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, seller 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 25% as of 2016. A further decrease to 22% in 2018 is currently expected, but not resolved.

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/gain 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 is 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 (eg, 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.

As part of the Norwegian stimulus package for the financial crisis the Government granted an additional start-deduction of 10% for any new acquirements in group d. However, the Ministry of Finance has proposed to remove the additional start-deduction for new acquirements from 2017.

Maintenance costs 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.[1] Group contributions may also, provided the conditions are fulfilled, be rendered between Norwegian PE's of foreign limited liability companies.

- The rendering and receiving taxpayer must be within the same tax group, ie, a common parent (Norwegian or foreign limited liability company) must directly or indirectly own and control more than 90% of the shares and voting rights in both companies. The ownership test is made at 31 December in the income year.[2]

- The group contribution must be lawful, eg, be resolved in accordance with Norwegian Company 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

[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.

in the real estate company is financed with debt[3] and the real estate company's income[4] is used to offset the holding company's loss).

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 2016) of a specifically defined profit ("taxable EBITDA"). This is the ordinary taxable income of the company after certain adjustments. The restriction

---

[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.

on interest expense is calculated separately for each separate tax payer. 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. Current year tax losses may, however, 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. An independent committee issued a proposal in 2014 which inter alia included a proposal to decrease the threshold from 5m NOK to 1m NOK, but this was not included in the 2016 National Budget.

Please note that the interest limitation rules and the arm's length principle operate alongside one another. If for example internal interest is partially or fully disallowed under the arm's length principle then 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 is not thinly capitalised. As there are no specific statutory regulations, a generally acceptable debt-to-equity ratio has not been set. The main issue for Norwegian tax purposes is what debt-to-equity ratio an independent lender would accept under the same circumstances. This assessment must be made on a case-by-case basis, where all relevant factors are taken into account (eg, current and expected cash flow, type of business, contract situation, level of interest-bearing debt, interest coverage, security etc).

In practice, the basic effect of a shareholders/intra-group loan (and/or shareholders/intra-group guarantees or similar arrangements for unrelated party loan) not fulfilling the arm's length requirement is:

- Non-deductibility of the part of the interest that is related to debt that could not have been obtained by the company on commercially acceptable terms on a 'stand-alone' basis

- No deductibility/income for the company for the same part of currency losses/gains

- Non-deductible interest payments may also be treated as deemed dividend and dividend taxation of the company's shareholders may be carried out on that basis (ie, the dividend distributions may be seen as unlawful and thus not comprised by the tax exemption method for corporate investors).

If real estate is acquired directly by a foreign taxpayer, it is recommended that any loans are established at the point in time of the acquisition of the real estate and with the real estate as mortgage. Later refinancing, ie, increase of loans or insertion of loans may be difficult.

Exchange gains and losses

Exchange gains/losses on debts are normally taxable/deductible. With respect to gains on long-term loans, using a 'revaluation account' for tax purposes implies that the year's net unrealised exchange loss is deductible while net unrealised gains will only have to be entered as income to the extent that there is an uncovered loss in the 'revaluation account'.

Capital gains and losses on the sale of property

Capital gains/losses on the sale of real property owned by both resident and non-resident taxpayers are taxable/deductible.

Normally, gains on sale of real estate, other depreciable property and non-depreciable property that is used for business purposes, may be transferred to a collective 'gains and loss account' to the extent the gains are not treated as income in the year of the sale. On a declining balance basis, at least 20% of such positive 'gains and loss account' must be entered as income annually. As a result it is effectively possible to achieve a partial deferral of income recognition for tax purposes. It is mandatory to transfer losses to the 'gains and loss account', which is charged with a maximum of 20% annually on a declining balance basis.

Capital gains and losses on the sale of shares in limited liability companies and ownership interest in partnerships

Norwegian tax resident limited liability companies' gains on shares in Norwegian limited liability companies and similar Norwegian entities (and certain foreign limited liability companies/similar entities) are tax-exempt under the Norwegian tax exemption method. To the extent a gain on shares in a Norwegian limited liability company is not taxable; losses on the shares are not deductible either.

Non-resident taxpayers' gains on shares in Norwegian tax resident limited liability companies and similar Norwegian entities are not taxable in Norway. If the shares are effectively connected to a Norwegian PE, gains will tax exempt and losses will be non-deductible to the extent the foreign company is comprised by the tax exemption method (ie, if the foreign company corresponds to a Norwegian limited liability company).

Norwegian or similar entities' (including certain foreign limited liability companies) capital gains on ownership interests in Norwegian partnerships (and equivalent foreign partnerships) are as a main rule, comprised by the tax exemption method.

However, capital gains in connection with realisation of an ownership interest in a Norwegian partnership or equivalent foreign partnerships are taxable if the partnership's value of shares etc which are not comprised by the tax exemption

method (eg, investments in companies in low tax jurisdictions), at any point in time during the last two years prior to realization 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 for instance 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 *Cadburry-Schweppes* case).

Dividend distributions covered by the tax exemption method that do not meet the conditions above, will still be subject to 25% tax on 3% of the dividends (effective tax rate of 0.75%).

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 carryforward and carryback

As of 1 January 2006, tax losses may be carried forward indefinitely. As of 1 January 2006 also, discontinuance of business activity in which the loss was incurred has no effect of the possibility to carry the loss forward. The carryforward may be lost

or reduced due to debt remission or bankruptcy. Finally, carryforward 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 to be 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, 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) is 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.

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, however, still apply.

---

[5] For instance, if the prevailing motive for acquiring a company with a loss carryforward is to use the loss, the loss may be discontinued due to the 'look-through'/'substance-over-form' regulations.

The Tax Act 14-90

A statutory anti-avoidance rule has been introduced as a result of the introduction of the exemption method for share gains. The rule applies to companies (and certain other entities) that have certain tax positions (eg, loss carryforward 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 carryforward 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).

If the statutory anti-avoidance rule is not applicable to a transaction or series of transactions, the non-statutory look-through regulation may, however, still apply.

Please note that there is currently a proposal for a new statutory anti-avoidance rule on public consultation. The consultation will end in June 2016, and it is expected that the Ministry of Finance will issue the final proposal in 2016 or 2017.

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 out 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 is changed 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 is provided that the building, or part of the building, is taken into use in business liable to VAT, or if leased out 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.

Adjustment of VAT shall only be made if the change of use of the property exceeds 10% compared to the utilization 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. The rules regarding valuation of real estate for tax purposes have, beginning in 2010, 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%. The municipality of Oslo has for instance 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.

Contacts

Advisory

Hildegunn Naas-Bibow
Tel: +47 95 26 01 18
E-mail: hildegunn.naas-bibow@no.pwc.com

Assurance

Geir Julsvoll
Tel: +47 95 260 540
E-mail: geir.julsvoll@no.pwc.com

Tax & Legal

Lars H. Aasen
Tel: +47 95 260 274
E-mail: lars.helge.aasen@no.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Philippines

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Philippines 3

Real Estate Investments – Philippines 4

Contacts 14

All information used in this content, unless otherwise stated, is up to date as of 10 June 2016.

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 a 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 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 and the Philippine Economic Zone Authority (PEZA) 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

Preface

This guide has been prepared by PwC, in coordination with its correspondent Law Firm, *Cabrera Lavadia and Associates*, and provides an introduction to the Philippines' tax and legal regime that applies to real estate investors.

Although this summary has been prepared to reflect the laws and regulations as of 10 June 2016, this document is for guidance only and action should not be taken without obtaining specific advice.

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.

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 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 or 2% 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 PHP; or
- Sale of residential house and lot or other residential dwellings not exceeding 3,199,200 PHP;
- Note also that 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 of 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) is subject to a capital gains tax (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 0.5% 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. It should be noted, however, that 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, however, that certain tax treaties exclude STT, which is an excise tax rather than an income tax, from the scope of coverage.

To avail of the treaty benefits, an application for tax treaty relief may be filed with the Philippine tax authorities for purposes of confirming entitlement to tax treaty relief. The first taxable event for purposes of filing the tax treaty relief application shall be the date of payment.

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 0.75 PHP for each 200 PHP, based on the par value of the shares (effectively 0.375%). However, if the shares are listed and traded through the PSE, the sale of said shares is exempt from DST.

Lease agreements on lands and tenements are subject to DST at the rate of 3 PHP for the first 2,000 PHP and 1 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 4th 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 3 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 7.5% FWT.

The long-term bank deposit (ie, with a term of 5 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 5th 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 3 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.

It has been held that in mergers, the loss carry forward of an absorbed corporation can only be availed of the said entity and cannot be extended or transferred to the merged or surviving entity.

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.

Real Estate Investment Trusts

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 can be claimed as tax deductions. Dividends paid by the REIT to overseas Filipino workers are not subject to income tax/withholding tax (WHT) for 7 years from the affectivity of the REIT Law, which was on 17 December 2009.
- Not being subject to MCIT.
- Reduced CWT of 1% on income payment to REITs.
- 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).
- Exempt from Stock Transaction Tax (STT) on any initial public offering and secondary offering of shares (STT rate 1% to 4%).
- 10% Final Tax on dividends unless lower treaty rate is applicable.
- REITs not considered as dealers in securities are not subject to 12% Value-Added Tax on sale of securities forming part of its real-estate related assets.

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.
- 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 (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 5 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

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 3 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.

Currently, there is a pending bill to amend the Code (ie, the proposed Senate Bill No. 1361**), wherein a collegial body named the 'Local Assessment Council' shall be** established to prepare the schedule of fair market values of real property, removing such from the responsibility of one Local Assessor.

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.
- 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.
  - Presently, Senate Bill No. 2036 is pending proposing to decrease the ad valorem tax rate on idle lands from 5% to 3%.
- 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

Contacts

Advisory

Mary Jade R. Divinagracia
Tel: +63 2 845 27282060
E-mail: jade.roxas@ph.pwc.com

Noel R. Custodio
Tel: +63 2 845 27283064
E-mail: noel.r.custodio@ph.pwc.com

Assurance

Roderick Danao
Tel: +63 2 845 27283065
E-mail: roderick.danao@ph.pwc.com

Tax

Malou P. Lim
Tel: +63 2 845 27282016
E-mail: malou.p.lim@ph.pwc.com

Sylvia R. Salvador
Tel: +63 2 845 27282058
E-mail: sylvia.r.salvador@ph.pwc.com

Legal

Alex B. Cabrera
Tel: +63 2 845 27282002
E-mail: alex.cabrera@ph.pwc.com

Jaffy Y. Azarraga
Tel: +63 2 845 27282116
E-mail: jaffy.y.azarraga@ph.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Poland

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents ... 2

Real Estate Tax Summary – Poland ... 3

Real Estate Investments – Poland ... 7

Contacts ... 23

All information used in this content, unless otherwise stated, is up to date as of 04 May 2016.

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%. 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.

Consolidation for income tax purposes is possible in Poland under specific and relatively strict conditions.

Thin capitalisation rules

As of 1 January 2015, the new thin capitalisation rules came into force.

Under these new rules the taxpayer is allowed to choose one of the two methods: the standard (default) method or alternatively so-called 'interest ceiling method'.

As far as the standard method is concerned, the law sets a maximum debt-to-equity ratio of 1:1 for loans drawn from qualifying lenders (ie, shareholder(s) holding directly or indirectly at least 25% of voting rights of the borrowing company, as well as 'sister' companies, if the same entity holds directly or indirectly at least 25% of voting rights of both the lending and the borrowing company). When this ratio is exceeded, interest paid on restricted loans, in relation to the part of loans exceeding the equity of the taxpayer will not be tax-deductible.

Equity for the purpose of calculation of the debt-to-equity ratio should generally cover all equity items of the taxpayer (including not only registered share capital, but also share premium, supplementary capital, retained earnings, current profits, etc), but excluding revaluation reserves and parts of equity resulting from subordinated loans, and certain parts of registered share capital.

Please note that under the grandfathering rules for loans granted until the end of 2014 (ie, where the cash has been physically transferred to the borrower until the end of 2014), the previous regime (based on the 3:1 debt-to-share capital ratio) still applies (even if the payment of interest is made after the end of 2014).

The taxpayer could also choose an alternative method of thin capitalization calculation (the so-called 'interest ceiling method'). Under this method interest deductibility limitations apply to both related and non-related loans and interest deductibility is capped by (i) a percentage of the tax value of the company's assets (excluding intangibles) and (ii) the amount of operating profits of the company. This method is however rarely chosen by the taxpayers and does not seem beneficial for real estate investment vehicles.

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.

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.

As of 1 January 2016 the anti-abuse clause came into force, based on which 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 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 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.

Currently, the Polish government considers redrafting the requirements regarding the withholding tax exemption for interest and royalties. Namely, it proposes to expressly provide that the condition for application of exemption from withholding tax on interest and royalties would be that the interest recipient is the beneficial owner thereof.

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 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.

As of January 2015, 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). Loans are generally subject to 2% CLAT, but a number of exemptions are available.

Capital gains on sale of property

There is no distinct capital gains tax regime in Poland. Capital gains are taxed at the general CIT rate of 19%, unless otherwise determined by the provisions of an applicable double tax treaty.

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

The Polish tax legislation currently does not include the general rule which would explicitly allow the tax authorities to disregard the tax implications of the transactions (or a sequence of transactions) if they prove that no substantial benefit other than the tax benefit could be expected by the taxpayer.

However, please note that draft law introducing General Anti Avoidance Rules (GAAR) is currently debated in the parliament and is generally expected to become law still in 2016.

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, that the Polish parliament has recently adopted regulations providing for limitations relating to acquisition of agricultural land. The new law generally restricts 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 new regulations have come into 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 applies only to land owned by the State or by 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 in specific cases, such as a breach of the usufructor's covenants. 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

Similar to other countries in the region, the tax system in Poland is still relatively new, and its rapid development has meant relatively frequent changes in tax legislation. In general, the change has been positive and the legislation is generally in line with EU standards.

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

Currently the Polish tax legislation does not include the general rule which would explicitly allow the tax authorities to disregard the tax implications of the transactions (or a sequence of transactions) if they prove that no substantial benefit other than the tax benefit could be expected by the taxpayer. There are only provisions which (i) oblige the authorities to take into account the intention of the parties and not only the literal wording of declarations of intentions of the parties (substance over form rule) when defining the substance of a transaction; (ii) oblige the authorities to derive tax consequences from a hidden legal act, if a legal act was performed in order to hide another transaction (ostensible legal actions test); (iii) enable the authorities to apply to a civil court for determining the existence or non-existence of a legal relationship or right, if the evidence collected in the course of a proceedings causes doubts as to the existence or non-existence of a legal relationship or right having tax consequences.

However, currently legislative works on General Anti-Avoidance Rules (GAAR) are in progress. Based on a draft law, the tax authorities would be able to disregard tax implications resulting from a structure applied by the taxpayer and assess an additional tax liability for the taxpayer, if they prove that such structures were artificial and were applied mainly to achieve substantial tax benefits. However, it might be possible to obtain a special opinion from the tax authorities to secure the tax implications of a given structure. Draft law introducing GAAR is currently debated in the parliament and is generally expected to become law still in 2016.

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.

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.

As far as individual tax rulings are concerned, the authority to issue such rulings on most of the individual matters belongs to the Minister of Finance, but in practice rulings are issued by designated Directors of Tax Chambers on behalf of the Minister of Finance. 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 Minister of Finance 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, as of 1 January 2016, 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, as of 2016 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 issued by/or on behalf of the Minister of Finance 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 Minister's 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 proposed 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 would not be protected.

However, the draft amendment to the Tax Ordinance provides for a new tax clearance instrument, ie, so-called 'protective opinion' which will be issued by the Minister of Finance. Please note, that protective opinions will be more expensive than in case of individual tax ruling (ca. €5,000) and 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.

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% (ie, 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% (ie, to 6%, given the current standard rate), but no time limit generally applies. Moreover, provided the tax return is corrected until 30 June 2016, the 50% reduction may also apply in case of such arrears.

On the other hand, as of 2016 in certain cases of VAT/excise duty arrears stipulated in the Tax Ordinance, the standard rate is increased by 50% (ie, to 12%). As a rule such an

increase applies (i) if the tax authorities reveal (in the course of tax 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.

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, with some exceptions. Namely, the permit should be obtained i.a. with respect to acquisition of agricultural and forest land made during the transition period ending 1 May 2016 (with some exceptions).

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 2–3 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, even if the real estate owned or held in perpetual usufruct by the company in question is of agricultural or forest character.

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.

New restrictions on acquisition of agricultural land

The new law (effective as of 30 April 2016) introduces 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 – will be 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 3,000 square meters 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 state Agricultural Property Agency.

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 10 years and – in principle – would not be allowed to sell this real property/give it into use of third parties.

Moreover, Agency of Agricultural Properties has the pre-emption rights covering:

- acquisition of the real estate of agricultural character (with some exceptions);
- 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, Agency's pre-emption rights would not be applicable).

Additionally, the Agency of Agricultural Properties 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 Agency of Agricultural Properties (to make a statement on acquisition of a real estate of agricultural character owned/held in perpetual usufruct by the company) also applies if:

- as a result of the actions indicated above, the shares in that company are transferred to another entity;
- 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'. In the period of 5 years following the legislation entering into force, real properties (and parts thereof) constituting the so-called 'agricultural portfolio of the state' would not be subject to sale. This general rule would not apply i.a. 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 i.a. technology/industrial park or storehouses);
- located in special economic zones;
- constituting agricultural properties of an area not exceeding 2ha.

Anti-monopoly consent

Under certain conditions, 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, 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 the recent years closed-end investment funds (FIZ) (in combination with certain partnerships) became 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

There is no distinct capital gains tax regime in Poland. Capital gains are combined with other business income of the taxpayer and taxed at the general CIT rate of 19%, 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.

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.

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.

Please note, that as of 1 January 2017 the standard VAT rate should automatically be reduced to 22% (instead of 23%) and the reduced VAT rate mentioned above should be decreased to 7% (from 8%). However, the Polish government is considering extension of the application of the higher rates.

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.

Financing real estate in Poland

Debt

Thin capitalization

As of 1 January 2015 the new thin capitalisation rules came into force. Under these new rules the taxpayer is allowed to choose one of the two methods: the standard method (which is applicable by default) or the alternative one.

Under the standard method the Polish entity must comply with the permitted debt-to-equity ratio in order to be able to fully use interest costs. The law sets a maximum debt-to-equity ratio of 1:1 for loans drawn from qualifying lenders, ie, shareholder(s) holding directly or indirectly at least 25% of voting rights in a Polish (borrowing) company, as well as sister companies, if the same entity holds directly or indirectly at least 25% of voting rights both of the creditor and the debtor company.

Part of the interest on the loan from a qualifying lender corresponding to the ratio of excess of the qualifying debt over equity to total qualifying debt that will not be treated as a tax-deductible cost. The ratio should be calculated as of the last day of the month preceding interest payment.

CIT regulations define the term 'loan' very broadly for thin capitalisation purposes. It should be understood as receiving funds subject to repayment, issuance of bonds, as well as deposits.

Equity for the purpose of calculation of the debt-to-equity ratio should cover all equity items of the taxpayer (including not only registered share capital, but also share premium, supplementary capital, retained earnings, current profits, etc), but excluding revaluation reserves and parts of equity resulting from subordinated loans. In addition, equity for thin capitalisation purposes is calculated without taking into consideration the part of the registered share capital which was not paid in, or was covered by contributions of **shareholders' loans and by the** interest on these loans (debt-to-equity swap), as well as with intangibles not subject to tax depreciation deductions (eg, know-how).

The definition of debt covers all kinds of liabilities (not only loans) towards direct or indirect shareholders having at least 25% of voting rights in the Polish borrower. In the case of calculating thin capitalization limitations for loans granted by the company, which has the same direct or indirect shareholder as the borrower, also the debts towards the lending company have to be included. Debt may be decreased by loans granted to related entities mentioned in the thin capitalization regulations.

Please also note that under the grandfathering rules for loans granted until the end of 2014 (ie, where the cash has been physically transferred to the borrower until the end

of 2014), the previous, less restrictive regime (based on the 3:1 debt-to-share capital ratio and applicable only to loans extended by direct shareholders and sister companies having the same direct shareholder) applies (even if the payment of interest is made after the end of 2014).

As stated above, the taxpayer may also choose an alternative method of thin capitalization calculation (the so-called 'interest ceiling method'). Under this method interest deductibility is capped by (i) a percentage of the tax value of the company's assets (excluding intangibles) and (ii) the amount of operating profits of the company.

In principle the percentage consists of the variable reference rate of the National Bank of Poland (currently 1.50%) increased by a margin of 1.25%. Thus, the current percentage cap would be 2.75%. The operating profit cap is 50%of the operating profit of the company. It does not apply to selected financial institutions.

If chosen, the alternative method covers all debt (also from unrelated parties) and has to be applied for at least 3 years.

The alternative method does not seem beneficial for real estate investment vehicles and is rarely chosen by the taxpayers.

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 is subject to CLAT at the rate of 0.5%. 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%. 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, ie, 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.

Taxes on capital

There are no separate capital taxes. Companies should, however, remember that capital increases are, generally, subject to notary fees and 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 2016 may not exceed the following:

- 0.89 PLN per square metre of land;
- 22.86 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.

Inter alia, liquidation proceeds and remuneration for compulsory or automatic redemption of shares in a company are treated similarly as dividends.

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.

Additionally, please note that as of 1 January 2016 the anti-abuse clause came into force, based on which 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, the dividend receipts are added to the worldwide income and 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.

Currently, the Polish government is considering redrafting the requirements regarding the withholding tax exemption for interest and royalties. Namely, it has been proposed to expressly provide that the condition to apply for exemption from withholding tax on interest and royalties would be that the interest recipient is the beneficial owner thereof.

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.

Note that as of January 2015 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.

Contacts

Advisory

Kinga Barchoń
Tel: +48 22 746-4178
E-mail: kinga.barchon@pl.pwc.com

Jakub Jonkisz
Tel.: +48 519507147
E-mail: jakub.jonkisz@pl.pwc.com

Assurance

Piotr Wyszogrodzki
Tel: +48 22 746-4277
E-mail: piotr.wyszogrodzki@pl.pwc.com

Maciej Wałęga
Tel: +48 22 746-4261
E-mail: maciej.walega@pl.pwc.com

Tax & Legal

Sławomir Krempa
Tel: +48 22 746-6874
E-mail: slawomir.krempa@pl.pwc.com

Marta Pabiańska
Tel: +48 22 746-4688
E-mail: marta.pabianska@pl.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Portugal

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Portugal 3

Real Estate Investments – Portugal 5

Contacts 23

All information used in this content, unless otherwise stated, is up to date as of 06 May 2016.

Real Estate Tax Summary – *Portugal*

General

Corporate and individual investors planning to invest in real estate located in Portugal may opt between indirect acquisition (ie, through investment vehicles), or direct acquisition.

Rental income

Resident companies and branches, ie, permanent establishments (PEs) of non-resident companies net rental income is 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) 7% 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 will be taxed at the income tax rate of 25% on cash basis. 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 may 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 taxation purposes, at a 2% annual rate for flats or apartments, offices and commercial property and at a 5% annual rate for industrial buildings. Depreciation is calculated under the straight-line method.

Land cannot be depreciated for tax purposes.

The property should also be subject to an impairment test and if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.

If any impairment loss related to the property is recognised and not deductible for tax purposes in the year on which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.

No accounting depreciation charge is allowed in case the company opts for booking the investment property at fair value. Nevertheless, for tax purposes investment property valued at fair value may be tax depreciated throughout the maximum period of its useful lifetime (ie, 100 years), at 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 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%.

Loss carry forward

The carry forward period for tax losses generated in 2012 and 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 reorganizations 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 or 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.

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 (ii) 7% 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 sale 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, the seller must either: (i) adjust the annual CIT return for the amount corresponding to the positive difference between the tax registration value and the amount stipulated in the sale agreement; or (ii) prove to the Portuguese Tax Administration that the price of the transaction was effectively lower than the tax registration value 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, which is deductible for tax purposes (eg, up to a maximum of 2% per annum for commercial property), except the part regarded as land.
- Impairment loss: Property should also be subject to an impairment test, and if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.

  If any impairment loss related to the property is recognised and not deductible for tax purposes in the year in which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.
- Future sale of the property: In such case, the computation of any capital gain results from the difference between the sales value minus the acquisition price (net of any accumulated tax-deductible depreciation charges and impairment losses that have already been considered as deductible for tax purposes) updated by an official monetary correction index (for real estate held over two years).

The main features of the fair value model for tax purposes are:

- Depreciation: Tax depreciation is allowed, throughout the maximum period of the investment property's useful lifetime (ie, 100 years), at 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, eg, 2% annually for flats or apartments, offices and commercial property; 5% annually for industrial buildings or hotels. Land and the capitalised expenses related to it cannot be depreciated. If the land value is not known or determinable, it is deemed to account for 25% of the acquisition cost of the property.

The carry forward period for tax losses generated in 2012 and 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 reorganizations 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 is 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 tax registration value. 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 tax haven country or jurisdiction 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 12 years (5 years after 2017).

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. The income earned by tax residents is still subject to a progressive surcharge up to 3.5%.

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 is withheld, or not, depending on the tax status of the entity paying the rent. 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 capital gains to the 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 purchase price. Duly documented improvement expenses, incurred in the previous twelve years, plus costs inherent to the disposal are added to the purchase price. In order to exclude purely nominal or inflationary gains, the purchase price is multiplied by the official monetary devaluation index.

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. The income earned by tax residents is still subject to a progressive surcharge up to 3.5%.

Nevertheless, 50% of the capital gains are not subject to tax.

Non-resident individuals

Non-resident individuals are subject to personal income tax on the capital gains arising from the sale of property located in Portugal, at the autonomous rate of 28%.

Net rental income for non-resident individuals is subject to an autonomous rate of 28%.

Residents from another country of the European Union (EU) or of the European Economic Area (EEA) may opt to have their capital gains or rental income taxed at the same rates as Portuguese residents, ie, between 14.5% and 48%, depending on the respective tax bracket (for residents in the EEA, the country in question must have a tax information exchange in place with Portugal). In addition, an additional solidarity rate of 2.5% on the taxable income between €80,000 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% tax rate may be reduced if the acquisition price does not exceed a certain amount, which is updated every year. Full exemption is also available for lower amounts (in 2016 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 tax registration value, appraised under the annual local property tax (IMI) rules. This tax is borne by the acquirer, whether resident or non-resident.

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. 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 restructuring or cooperation projects, upon previous request and approval, 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;

  - 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 a normal and usual basis, ie, on a business basis. 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 tax registration value 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 Stamp Duty on residential real estate with a TRV of at least €1m

Residential real estate and land for construction whose construction is authorised or intended for residential purposes, with an official tax registration value of at least €1m, is subject to an additional taxation at SD level, levied at a flat rate of 1% on the official tax registration value.

Urban real estate, irrespective of its type, with an official tax registration value of at least €1m, when owned by a an entity domiciled in a tax haven (not an individual), is subject to an additional taxation at SD level, levied a flat rate of 7.5% on the official tax registration value.

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 tax registration value 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 tax registration value 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 from 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.
- 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.

Urban rehabilitation

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 Madeira island) and; (ii) 18% (on the Azores islands).

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 transfer/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 fraction 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 whole of the property unit.
- The property unit is allocated to the undertaking of VAT-able transactions, ie, those that give a right to deduct input VAT.
- In the specific case of lease agreements, the annual rent should amount to at least one-twenty-fifth (1/25) of the acquisition price or construction cost 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 tax registration value 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.

2. 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, in, the 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 deduction on property is subject to a VAT claw back 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.

Tax aspects

Corporate tax

Resident companies

If shares in a company owning property are acquired by another company, the latter company must value the shares in the acquired company at the acquisition price.

Contrary to a direct purchase of property, the purchaser of the shares in a property company will not benefit from any step-up in the value of the property for taxation purposes, since for corporate tax purposes, the company owning the property must continue to value the property at the original acquisition price, even if booked at fair value. Hence, the fiscal book 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 are 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 above conditions are not met, WHT will be levied. 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 equal to the difference between transfer price and acquisition price 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 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 tax treaty that does not give the right to Portugal to tax such capital gains.

Personal income tax

Resident individuals

Dividends are subject to a 28% WHT. The WHT 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. The income earned by tax residents is still subject to a progressive surcharge up to 3.5%. 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 purchase price 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 purchase price and to the sale 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 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 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 fund

General

Real estate funds and the management company

The sole purpose of real estate 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*, 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 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 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 units divided into horizontal property 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 funds

Taxation at the real estate fund level

For CIT purposes, the taxable profit of real estate 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 fund is exempt from local and state surtax, 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 12 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 fund is also subject to stamp duty levied on its NAV at a rate of 0.0125%. The stamp duty is assessed quarterly, in March, June, September and December of each year.

Property acquired/owned by the real estate 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 permanent establishment 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.

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 fund is not subject to IMT. However, an exception to this principle applies to the acquisition of units of privately placed close ended real estate 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 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 the 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 regime of SIIMO

As a general rule, the SIIMO are taxed under the same rules as apply for real estate funds for both income and property taxes.

Financing the acquisition of Portuguese property

Equity financing

Portuguese tax aspects

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

Portuguese tax aspects

Deductibility of interest

The general principle regarding the acceptance of costs and expenditures as tax-deductible 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 capping rule the deductibility of net financial expenses is limited to up to the higher of the following limits: (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).

The variable cap is subject to a transitional period under which shall be gradually reduced (40% in 2016 and 30% from 2017 onwards).

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 tax treaty with Portugal.

Under the Interest-Royalty Directive no WHT is levied. The minimum shareholding 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 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.

Contacts

Advisory

António Rodrigues
Tel: +351 213 599-309
E-mail: antonio.rodrigues@pt.pwc.com

Assurance

César Gonçalves
Tel: +351 213 599-436
E-mail: cesar.goncalves@pt.pwc.com

Tax

Jorge Figueiredo
Tel: +351 213 599-618
E-mail: jorge.figueiredo@pt.pwc.com

Elsa Silva Martins
Tel: +351 213 599-625
E-mail: elsa.silva.martins@pt.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Romania

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Romania 3

Real Estate Investments – Romania 6

Contacts 19

All information used in this content, unless otherwise stated, is up to date as of 25 May 2016.

Real Estate Tax Summary – *Romania*

General

In the Romanian law is enshrined the principle of free transferability of assets, 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 natural persons and legal entities (regardless of the citizenship of the shareholders) are free to acquire land.

Foreign citizens, stateless persons and legal entities are allowed to 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 are taxed in Romania at 16%. 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 of 2017, capital gains obtained by individuals are also subject to individual health contribution (5.5%) up to a certain limit.

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 a deemed expenses deduction of 40%) is subject to individual income tax at a flat rate of 16%. Rental income is also subject to individual health contribution (5.5%).

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.

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

A new classification method was introduced as regards the buildings. Thus, a building may be residential, non-residential or intended for mixed usage. In case of residential buildings owned by individuals, as well as by legal entities, the building tax is calculated by applying a rate between 0.08%- 0.2%, to the taxable value of the building. In case of non-residential buildings owned by individuals, as well by legal entities, the building tax is calculated by applying a rate between 0.2- 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 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 general 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, 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 notarised form for the transfer of ownership over houses is mandatory starting July 2010.

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.

Note that more recently (ie, 1 October 2011), Romania adopted a new Civil Code which stipulates that the registration with the Land Register is made for the validity of the ownership transfer and not only for ensuring its effectiveness against third parties. However, said provisions will only enter into force after the full cadastral mapping of real estates in Romania is completed.

The National Cadastre and Land Registration Agency regulates the real estate property registration in Romania, a role taken over from the Ministry of Justice. This Agency also coordinates and oversees the performance of cadastral work at the national level.

Ownership and other real rights to an immovable asset are to be entered in the real estate information register (ie, Land Register), solely on the basis of deeds creating or transferring rights *in rem*, which have to be concluded with the observance of the authentic (notarised) form.

Upon authentication of an instrument establishing, modifying or extinguishing a legally enforceable right in property, the notary public requests a Land Register abstract for authentication. For the valid conclusion of a transferring deed of ownership, the owner is obliged to present the notary public with a fiscal certificate attesting that there are not any outstanding taxes related to the respective property. During the term of validity of the abstract for authentication, the Real Estate Registry may only register the transaction for which the abstract was issued.

After the public notary has prepared the deed of conveyance, which alters, establishes or extinguishes a legally enforceable right in real estate, the notary shall register the operation with the Land Register.

Time-sharing legislation

The Government Emergency Ordinance that transposes Directive 2008/122/CE of the European Parliament and of the Council on the protection of consumers in respect of certain aspects of timeshare, long-term holiday product, and "resale and exchange contracts" has also taken effect starting from 23 February 2011.

Mortgaging real estate

Mortgages are created under authentic deeds and must be recorded in the Land Register to have an effect towards third parties.

Mortgages are created only over land/buildings as a whole or over the share owned by any of the co-owners. The creation of mortgages over a future asset is subject to compliance with specific regulations regarding mortgage credit for real estate investments, based on the prior registration with the Land Register of the building permit and the partial delivery and acceptance minutes.

In order to foreclose on the mortgage, the mortgagee (eg, a bank) must resort to a bailiff to start the foreclosure procedure. Commencement of this procedure is registered in the Land Register. Objections can be filed against the foreclosure procedure in front of a competent court, which may suspend the foreclosure procedure based on a specific request to this effect.

In the event of bankruptcy, the mortgagee submits its claim to the liquidator and has priority in the sale proceedings of the asset mortgaged over any other receivables, except for the taxes, stamps and other liquidation costs relating to the sale of the asset.

Public–Private Partnership (PPP) legislation

The PPP legislation includes Law 178/2010, and, in a broader view, also Emergency Ordinance no. 34/2006 on public procurement and concessions contracts. All these normative deeds are currently under an amendment process before the parliamentary chambers, with chances for new provisions to enter into force this year.

In accordance with the above provisions, assets being private property of the state resulting from the implementation of a PPP project, as well as the plots of land used for the project, may be alienated, mortgaged, pledged or posted as security for the benefit of third parties, provided the prior approval of the owner of the land has been obtained.

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 generally 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/income tax, unless more than 10% of the shares are held for more than 1 year. 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 1 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

Income from the transfer of real estate is taxed as follows:

- for real estate owned for less than three years:
    - for values up to 200,000 RON the income tax is 3%
    - for values exceeding 200,000 RON, the income tax is 6,000 RON + 2% of the amount exceeding 200,000 RON.
- for real estate owned for more than three years:
    - for a value up to 200,000 RON, the income tax is 2%.
    - for a value exceeding 200,000 RON, the income tax is 4,000 RON + 1% of the amount exceeding 200,000 RON.

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 (an income tax of 1% is levied if the 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 notary public. 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 notary public notifies the transaction to tax authorities. The tax remittance deadline is day 25 of the month following that when the income was withheld.

Taxation of sale of shares in the case of Romanian and/or non-resident individuals

Capital gains from sale of shares are taxed in Romania at 16%.

The obligation of calculating and paying the income tax from the transfer of securities lies with the taxpayer. As of 2017, also health contribution (5.5%) would be due on investment income (certain aggregation rules apply).

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.

In general, starting with 2010, all Romanian companies are subject to an advance payment tax system (quarterly payments 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. They may appoint a tax agent/fiscal representative for meeting the above requirements for payment of profit tax and the submission of annual tax returns.

Basis of taxation

The taxation of an owner of real estate property is as follows:

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 16%. Rental income is also subject to individual health contribution (5.5%).

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 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.

Rental income – 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 depreciable.

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 and the ratio between the residual value and the principal is less than or equal to the ratio between the normal maximum useful life, minus the leasing period, and the normal maximum useful life; the leasing period exceeds 80% of the normal useful life of the goods subject to leasing (for the purposes of this definition, the leasing period includes any period for which the leasing contract may be extended); the total value of the leasing rates, ancillary expenses excluded, is higher than or equal to the entry value.

An operational leasing contract is any leasing contract concluded between the lessee and the lessor who transfers to the lessee the risks and benefits related to the ownership over the leased goods except for the risk of selling the goods at their residual value, and which does not fulfil the conditions of financial leasing. The risk of selling the goods at their residual value occurs when the purchase option is not exercised upon commencement of the agreement or when the agreement expressly provides for the return of the goods.

Under financial leasing, the lessee (user) is treated from a tax perspective as the owner, whereas under operational leasing it is the lessor that is treated as such.
The depreciation of assets that are the object of a lease agreement may be made by the lessee, under financial leasing, or by the lessor, under operational leasing. With financial leasing, the lessee deducts interest, and with operational leasing, the lessee deducts rent (leasing instalment).

Revaluation of fixed assets

Companies are allowed to revalue their fixed assets at the end of each year, according to their own accounting policies. Starting with 1 May 2009, the step-up in value is not effective for tax purposes when calculating depreciation expense. The same principle would apply 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

Taxable losses can be carried forward for seven consecutive years (starting with losses incurred in financial year 2009).

Value-added tax (VAT)

Real estate operations

VAT exemption with the option for taxation

Under the current 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, based on a notification submitted to the tax authorities.

The sale of real estate property (except for the sale of new buildings and building land) is also treated as a VAT exempt operation without deduction right. If the exemption is not favourable (ie, as the initial input VAT can become a cost in whole or in part), VAT-registered persons can opt to tax such operations, based on a notification filed with the tax authorities.

The supply of land on which a structure sits, but where demolition is in progress, would be treated from a VAT perspective as a sale of land.

Mandatory taxation

As mentioned above, sale of new buildings and parts thereof and building land is taxable with 20% VAT. Staring with 1 January 2017 the standard VAT rate will be reduced to 19%.

A new building (or parts thereof) is one that is sold by the end of the year following its first usage/occupation. Any construction that has been transformed insofar as the cost of its transformation exceeds 50% of the building's market value is also considered a new building. Building land is deemed any unimproved/improved land on which constructions can be raised.

The reduced VAT rate of 5% applies to dwellings delivered as part of social policy, including old people's homes, retirement homes, orphanages and rehabilitation centres for children with disabilities. The category also includes 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 dwelling acquired by any single person or family is less than 450,000 RON exclusive of VAT. The reduced VAT rate is also apply to the supply of the land beneath the dwelling on the condition that it does not exceed 250 square meters, including the footprint of the dwelling.

Any unmarried person can purchase a house under the social policy, provided that she/he did not acquire in the past another house with 5% VAT. Also, any family can purchase a house under the social policy, provided that the husband or the wife, separately or together, did not acquire a building in the past with 5% VAT.

Moreover, it should be noted that, starting with 1 January 2016, transactions consisting in supply of buildings/land between persons registered for VAT purposes in Romania shall be subjected to the simplification measures, ie, the beneficiary shall have the obligation to report in its VAT return both the input VAT and the output VAT. More specifically, for supply of buildings / land, which qualify as taxable operations due to the real estate nature, starting with 1 January 2016, the supplier shall issue invoices without VAT, and the beneficiary will account for VAT under the reverse charge mechanism, providing that both the supplier and the beneficiary are registered for VAT purposes in Romania.

VAT deduction right

Any taxable person has the right to deduct the VAT related to acquisitions, if these are destined to be used for generating taxable revenues.

Taxable persons performing acquisitions related to the construction of real estate to be used for operations both with and without deduction right will be able to deduct fully VAT during the investment process, after which the deducted VAT will be adjusted accordingly, depending on the actual use of the investments with respect to the construction of real estate.

Input VAT adjustment

The input VAT related to a real estate property should be adjusted over a period of 20 years, provided the landlord /lessor does not opt to tax the rental fees/lease instalments or the seller does not opt to tax the sale transaction. The adjustment period starts on 1 January of the year in which the real estate is commissioned and applies only for real estate commissioned after 1 January 2007.

The applicable adjustment period is five years (transitory regime) for real estate commissioned/modernised/purchased before 1 January 2007. However, if such real estate is modernised after 1 January 2007 and the value of this modernisation exceeds 20% of the real estate value, then a new adjustment period of 20 years is applied for the value of the modernisation. This new adjustment period starts on 1 January of the year in which the modernisation is commissioned.

The adjustment should be made in accordance with the percentage of the real estate property rented/leased/sold within the VAT-exemption regime, insofar as such transactions are performed within the 20-year adjustment period (5-year, under the transitory regime). The adjustment of the VAT deduction right should be performed one-off, when the destination of the goods change (eg, from exempt without deduction right to taxable and vice versa).

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.

The partial or total transfer of assets (ie, transfer of a going concern) performed as a result of other operations than the spin-off or merger (namely, sale or contribution in kind to the share capital of a Company) is not considered supply of goods provided that they can form an independent unit capable of carrying out an economic activity and the beneficiary is a taxable person established in Romania.

In addition, the beneficiary is regarded as the assignor's successor for purposes of adjustment of the VAT deduction right.

In case VAT is charged on top of the value of the transaction the tax authorities will allow the deduction of the related VAT at the level of the beneficiary provided that the VAT taxation regime was not applied for tax optimisation reasons.

Import of equipment

VAT on imported goods is paid in customs, except for imports made by taxable persons registered for VAT purposes that obtain an import VAT deferment certificate from the customs authorities. For these, the VAT is not paid in customs, but shown in the VAT return as both input and output VAT. The ceiling 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 this case, VAT is not paid in customs, but it has to be reported in the VAT return both as input and output tax.

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

Although in theory 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 it is a lengthy procedure (especially in Bucharest), based on a prior tax inspection, at least in the first 12 months of activity. Subsequently, the company can benefit from a fast VAT refund, if it achieves a low score in the risk analysis performed by the tax authorities. Due to budget shortages VAT refunds are being delayed. However, 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 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, provided that 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

A 16% withholding tax rate generally applies on 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 from the EU (holding for more than two years at least 10% of the 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 payments made between related parties, provided the conditions of association and a 2-year 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.

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:

Value of the transaction RON	Amount of the fees RON
Below 15,000	2.2% but no less than 150
From 15,001 to 30,000	330 + 1.6% for the amount exceeding 15,001
From 30,001 to 60,000	580 + 1.3% for the amount exceeding 30,001
From 60,001 to 300,000	970 + 0.9% for the amount exceeding 60,001
From 300,001 to 600,000	3,130 + 0.65% for the amount exceeding 300,001
More than 600,001	5,080 + 0.44% for the amount exceeding 600,001

However, certain discounts may be applied, eg, a 15% discount if the buyer is a lawyer or a 30% discount for the sale purchase agreements concluded under the government state aid program 'First Home'.

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 for companies and 0.15 % for natural persons.

Other taxes

Other taxes and charges, which could be material, 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.

Considerations on financing

Should the investment in the real estate project be financed through a loan taken up by the Romanian company, the deductibility of interest and foreign exchange losses is subject to certain limitations (including thin capitalisation rules) as set out in the Romanian Fiscal Code.

The first rule limits the deductibility of interest on loans contracted with parties other than credit institutions to a certain limit. For loans denominated in foreign currency the limit is currently set at 4%; this limit can be updated yearly. The limit for RON loans is the reference interest rate indicated by the National Bank of Romania for loans denominated in local currency RON. For your reference, the NBR interest rate is 1.75% starting with 7 May 2015. Interest exceeding this limit is non-deductible and cannot be carried forward. Interest paid to credit institutions, as well as interest related to bonds traded on a stock exchange is also exempt from this rule.

The second rule is the general thin capitalisation rule. This rule states that if a company's debt-to-equity ratio is higher than three to one, or if the company's equity is negative, the total amount of interest due and the net foreign exchange losses cannot be deducted from a tax perspective in the year in which they are accounted for. However, these expenses are carried forward to future years and they may be deducted at once in the year when the debt-to-equity ratio is 3:1 or less. Please be aware that only loans with a term of over one year can be taken into account for this rule.

As with the rate restriction, loans granted by credit institutions or bonds listed on the stock exchange are not subject to these rules.

In order to compute the debt-to-equity ratio, the total debt should also include interest-free shareholder loans with a maturity of over one year.

For purposes of applying the thin capitalisation rules, equity includes share capital, reserves, retained earnings, current year earnings and other equity elements. Both debt and equity are calculated as the average of values at the beginning and at the end of the period for which profit tax is calculated.

Accounting requirements for Romanian companies

Accounting Law 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 3 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 shall be 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 3 years, the building tax rate is increased to 5%.

For non-residential buildings owned both by 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 construction

The main permits and authorisations for construction are as follows:

- 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. Authorisation of the organisation of construction site works. This tax is assessed at 3% of the value of construction organization works.

Please note that there are also two other taxes applicable to constructions, which are not payable to the local budget, the most relevant being:

- Fee to the Construction Inspectorate. A monthly fee needs to be paid by companies to the Construction Inspectorate, amounting to 0.7% 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.**

Contacts

Advisory

Radu Stoicoviciu
Tel: +40 21 225-3620
E-mail: radu.stoicoviciu@ro.pwc.com

Sorin Petre
Tel: +40 21 225-3629
E-mail: sorin.petre@ro.pwc.com

Assurance

Francesca Postolache
Tel: +40 21 225-3000
E-mail: francesca.postolache@ro.pwc.com

Tax

Mihaela Mitroi
Tel: +40 21 225-3717
E-mail: mihaela.mitroi@ro.pwc.com

Diana Coroaba
Tel: +40 21 225-3692
E-mail: diana.coroaba@ro.pwc.com

Alexandra Smedoiu
Tel: +40 21 225-3681
E-mail: alexandra.smedoiu@ro.pwc.com

Valentina Radu
Tel: +40 21 225-3448
E-mail: valentina.radu@ro.pwc.com

Legal

Anda Rojanschi
Tel: +40 21 225-3721
E-mail: anda.rojanschi@david-baias.ro

Georgiana Balan
Tel: +40 21 225-3496
E-mail: georgiana.balan@david-baias.ro

www.pwc.com/goingglobal

Real Estate Going Global Russia

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Investments – Russia 3

Contacts 11

All information used in this content, unless otherwise stated, is up to date as of 25 April 2016.

Real Estate Investments – Russia

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. In Russia, flexibility is a critical success factor for structuring any real estate investment, and comprehensive due diligence prior to any transaction is vital.

Possession of Russian land

The land code in effect since 2001 provides foreign legal entities with the right to purchase and own land plots, subject to some restrictions depending on the location of the plot (locations near state border, agricultural land, etc). The land code also gives preferences to companies (including foreign legal entities) in acquiring the land plots on which buildings owned by these companies are located. Nonetheless, in practice, barriers to private land ownership continue to exist. Currently the private ownership of land is extremely difficult to achieve in many locations, especially the Moscow city centre. In such locations, it is still generally more common for a property owner to acquire a 49-year lease rather than to own the land. The local rules governing the ownership of buildings and structures are less restrictive and many of these are owned by domestic and foreign legal entities and individuals.

Profits tax

Rental income

Rental income of landlords operating through a Russian subsidiary or a permanent establishment (PE) (branch) of a foreign legal entity is subject to Russian profits tax. Taxable profits are calculated as gross revenues less most economically justified business-related expenses, supported by relevant documentation.

Taxable profit is calculated on the basis of tax accounting records. All tax accounting entries as well as relevant tax returns are prepared in Russian roubles.

Profits from rental activities accruing to Russian entities and to foreign entities with a permanent establishment in Russia are subject to the maximum corporate profit tax rate of 20%. The tax is distributed between the federal (2%) and regional (18%) budgets, with regional authorities having the right to lower the regional share in the rate down to 13.5% for certain categories of taxpayers, although such reductions are not common in the real estate industry.

Rental income from immoveable property received by foreign legal entities that do not hold the property through a PE in Russia is generally subject to withholding income tax levied on gross rentals at the rate of 20%. Double tax treaties do not provide reduced rates of withholding tax with respect to such rental income from immovable property.

In repatriating income from rental property held in a Russian legal entity, dividends payable to foreign legal entities are generally subject to a 15% withholding tax, subject to reduction under an applicable double tax treaty. For property held directly by

a foreign legal entity through a PE in Russia, there is no further Russian withholding tax (after normal taxation of the branch profits) on distributions of branch profits to the head office.

In a structure with two Russian entities in the chain of ownership, dividends paid from one Russian legal entity to another Russian legal entity would generally be subject to a 13% dividend withholding tax (the Russian entity recipient would not pay additional profits tax on the received dividends). In cases where a Russian legal entity owns shares in a non-Russian legal entity, dividends received would also generally be subject to Russian tax at a rate of 13%. A 0% profits tax rate applies to dividends received by a Russian company if it owns no less than 50% of the capital of the subsidiary (both Russian, and foreign other than established in a country being in a 'blacklist' of the Russian Ministry of Finance) for a period of no less than 365 calendar days. The Russian Ministry of Finance blacklist includes offshore countries and countries that do not support the exchange of information procedures. When dividends received by a Russian company do not qualify for the 0% rate, the 13% rate applies.

On debt financing of Russian property companies or branches of foreign entities, interest payments to non-resident companies would generally be subject to 20% withholding tax, subject to an applicable double tax treaty relief. Effective January 1, 2015, Russian tax legislation incorporated the concept of "beneficial ownership". This has introduced the notion of being able to demonstrate the ability to determine "economic fate" of received income as well as proper legal basis for receiving such income. The main test of beneficial ownership entails testing for transfer of the income amount (in any form including interest, dividends, royalty) to another party, who would not enjoy any tax benefits if it had received the payment directly because it is incorporated in a country with no DTT with Russia. The law gives the right to the tax agent (ie, the payer of income) to require in addition to certificate of tax residency a confirmation that the recipient of income is the beneficial owner of the income. Starting from 1 January 2017 obtaining of such confirmation by the payer of income will be mandatory for the purposes of application of DTT benefits.

Profits' tax-deductible expenses

The major peculiarities and limitations on deductibility of expenses in relation to real estate activities are set out in the subsections below.

Tenant's capital improvements

Inseparable capital improvements of leased objects that are not reimbursed to tenants by lessors would be depreciated by tenants during the lease term at rates calculated on the basis of useful life of the inseparable improvement (eg, lift) or, in case this particular inseparable improvement is not named in the statutory classification of fixed assets, on the basis of useful life period of the fixed asset (ie, building) itself. This means that in most cases the lessee of a building would be able to deduct for profits tax purposes only part of the cost of such improvements (since the useful life of buildings/inseparable improvements typically exceeds lease terms).

Depreciation

As a general rule, depreciation of fixed assets can be charged under a straight-line or reducing balance method. However, tax depreciation of buildings should generally be on a straight-line method only. Minimum annual depreciation rate for buildings is 3.33% and could be higher for certain types of buildings. Tax depreciation is charged on the historic cost of the building, net of recoverable VAT.

Taxpayers have the right to deduct for profits tax purposes the cost of investments into fixed assets of up to 10% (up to 30% in relation to fixed assets belonging to depreciation groups from 3 to 7) of the initial cost of the fixed asset in the period in which depreciation of the relevant asset starts (depreciation premium); this allowance applies also to capital improvements.

However, if a taxpayer applied a depreciation premium and then sold to the related party the relevant fixed asset within five years since the date of putting the fixed asset into operation, the depreciation premium should be recaptured and included in the taxable income of the taxpayer.

The useful life of a fixed asset, and hence the rate of depreciation to be applied for profits tax purposes, is established at the discretion of taxpayers within the limits established by the Government for various categories of fixed assets.

Most types of buildings cannot be depreciated over less than 30 years using the straight-line method (although some limited types of buildings can have a shorter useful life). Land cannot be depreciated.

Costs related to acquisition/lease of land

Costs related to acquisition of land from the state or municipal authorities may be profits tax-deductible under a special procedure (generally either evenly over a period of at least five years or in amount not exceeding 30% of taxable base of the previous tax period until the total amount is expensed). These provisions apply to taxpayers who enter into the relevant sale-purchase agreements within the period from 1 January 2007 to 31 December 2011.

Starting from 1 January 2012 costs related to acquisition of land plots (irrespective of who is the seller) are not deductible for profits tax purposes other than as a deduction against proceeds on any future sale with special rules for deduction of losses.

Costs related to lease of land (ie, rent payments) are generally profits tax-deductible provided that general criteria of economic justification and proper support by primary documents (eg, lease agreement, invoices, acts of acceptance, etc.) are met.

Interest deductibility

Interest on debt taken out to finance business activities including investments in immovable property is generally profits tax-deductible, subject to certain specific limitations outlined below.

If the loan is recognized as controlled under the transfer pricing rules, those rules should be taken into account in determining the interest recognized for profits tax purposes. An exception to this general rule is specifically envisaged for controlled loans where interest rates are within safe harbour limits allowing the borrower or lender to recognize interest calculated on the debt obligation at the actual rate if it falls within the threshold. In particular, if a debt obligation is recognized as a controlled transaction and the loan is arranged in roubles, the ranges of threshold values of interest rates for debt are 75% to 125% of the CBR's key interest rate from 2016. For debt obligations set in currencies other than roubles, safe harbour limits refer to LIBOR/EURIBOR/SHIBOR rates increased by various ranges depending on the currency. If the interest rate in the debt obligation is fixed, the Central Bank's key rate (LIBOR/EURIBOR/SHIBOR rates) valid for the borrowing date should be applied. If a floating rate is utilized, the Central Bank's key rate (LIBOR, EURIBOR, SHIBOR rates) valid for the date of recognition of interest as income (expense) is to be applied.

Thin capitalisation rules

Where a Russian legal entity obtains loans from a foreign company that directly or indirectly owns more than 20% of the charter capital of the Russian company (**'Substantial Shareholders') and the debt**-to-capital ratio exceeds 3:1 (for banks and companies engaged exclusively in financial leasing the ratio is increased to 12.5:1), the Russian thin capitalisation rules may be applied. In such a case, the interest expense on the loan will be only partially deductible. The deductible portion will generally be equal to the interest on the amount of the loan not exceeding 3 times the share of the Substantial Shareholder in equity (or 12.5 times for banks and companies engaged exclusively in financial leasing). Under the domestic tax legislation the portion of interest that is deemed non-deductible under the thin capitalisation rules would be reclassified as a dividend and taxed correspondingly. The notion of controlled debts for thin capitalisation purposes also includes debts obtained from Russian organisations that are affiliated with the Substantial Shareholders, as well as debts in relation to which such affiliated person or Substantial Shareholders act as guarantor or otherwise secure the debt with certain exceptions.

Starting in 2017 the changes to the thin capitalisation rules will be introduced where the most significant change would involve expanding the scope of thin capitalisation rules to include loans from foreign affiliated person with the Substantial Shareholders that do not hold a direct or indirect interest in a Russian borrower.

Loss carryforward

Russian legal entities and foreign companies having a PE in Russia can carry losses forward and offset them against profits in future years. Losses incurred in a particular year may be used in any year over the subsequent ten years.

Where buildings and other fixed assets are sold at less than net tax book value, losses on such disposals should be claimed for deduction in equal parts over the remaining useful life of the property sold.

Taxation of capital transactions in property

Taxable profits from sale of property by Russian companies and branches of foreign entities are calculated as gross sales proceeds less the net tax book value of the property. Profit from the sale of property is subject to a general profits tax rate of 20%.

If Russian immovable property is sold by a foreign company without a PE in Russia, the purchaser is required to withhold tax at the rate of 20% of the capital gain if the vendor can confirm the acquisition costs with appropriate documents; otherwise, the 20% tax rate should be applied to the gross sales price. No exemption can be obtained under double tax treaties. The same rates and rules apply to the sales of shares in companies which directly or indirectly holds Russian real estate and such real estate constitute more than 50% of their assets; this income, however, may be protected from Russian tax under certain (although not all) applicable double tax treaties. It should be noted that capital gains from disposals of shares in companies and relevant derivatives are fully exempt from withholding tax if the shares qualify as publicly listed securities.

0% profits tax rate applies to income from sale of non-quoted (for the full period of holding by seller) shares in Russian companies in case at the moment of realisation

these shares were held by the seller for not less than five years. This exemption applies only to the shares acquired after 1 January 2011. There is an uncertainty if this exemption may apply to such income of foreign companies.

Contributions to charter capital

For profits tax purposes, the cost of the property received as a contribution to the charter capital of the taxpayer generally equals the cost (net book value) determined on the basis of tax accounting of the contributing party; potentially, expenses incidental to the contribution may be taken into account. Special rules are established for situations where contributing parties are foreign legal entities or individuals. In case appropriate documentary evidence of the cost of the property is unavailable its cost will equal zero for profits tax purposes.

Value-added tax (VAT)

Generally, VAT is charged on the supply of goods, works and services in the territory of the Russian Federation at the rate of 18%.

VAT is payable on an accrual basis.

Rental of property is generally subject to VAT. Where the parties to the lease arrangement are located in different countries (for example the landlord is located outside Russia) for VAT purposes, the service is considered to be performed where the real property is located.

Under special provisions based on the concept of reciprocal treatment, accredited individuals and accredited foreign entities of some 100 countries are exempt from VAT on rental costs.

Taxpayers are required to reinstate VAT they previously recovered if they start using relevant fixed assets for non-VAT-able activities. In particular, VAT incurred on acquisition/construction of immovable property should be reinstated unless the fixed assets have been fully depreciated or have been used by the taxpayer for more than 15 years. This rule affects, for example, a real estate company that after, say, five years of leasing out a building starts leasing (part of) the premises to accredited foreign legal entities that have the right to enter into a non-VAT-able lease. Such reinstated VAT may however be expensed (deducted for profits tax purposes).

VAT is charged on capital transactions in property (other than when a disposal is made by an individual that is not an individual entrepreneur and in some other cases). Owners of the premises (eg, investors) are in principle entitled to recover VAT incurred in relation to completed stages of construction under the general VAT recovery rules, ie, without waiting for commissioning of the building. Moreover, starting from 2009, VAT on advances paid to contractors is in principle recoverable in the period when the advance is paid, ie, before the acceptance of completed construction stages.

Where a finished building is purchased by an investor for use in a business that is VAT-able, input VAT incurred could in principle be recovered immediately or offset against output VAT provided certain requirements for input VAT recovery are met.

Sale and lease of residential property is generally exempt from VAT. However, in case of assignment of property rights in relation to residential premises, VAT is charged on the difference between the sale price of the rights and the cost of the rights, at

18/118 rate (eg, if during a pre-construction sales period a taxpayer obtains a right to purchase a residential unit at a pre-determined price, and then transfers that right to another taxpayer for consideration).

Special VAT rules apply when a building is constructed by the developer's own workforce ('self-construction'), rather than under a contract with a separate construction company. The value of self-construction works is included into the VAT-able base. However, such VAT could be claimed for recovery in the same tax period.

Transactions with securities (including shares in a property holding company) are exempt from VAT.

Certain types of imported technological equipment (components and spare parts thereof), analogues of which are not produced in Russia, are exempt from Russian VAT provided that they are mentioned in a special list approved by the Russian Government.

In the case of a contribution of assets to the charter capital of an enterprise, the contributing party shall reinstate VAT on contribution of fixed assets to the charter capital of a company that it previously recovered in relation to such fixed assets, in an amount proportionate to the net book value of the fixed assets. This reinstated VAT, however, is subject to recovery for the receiving party.

Lease of land is generally subject to VAT (there are some exemptions for cases where land lease payments are made directly to the state or municipal bodies). Sale of land plots (parts of land plots) is not subject to VAT.

Other taxes

Property tax

Property tax is levied at a maximum rate of 2.2% (the local authorities have the right to reduce the rate, but tend not to). The property tax base for Russian legal entities and PEs of foreign legal entities is generally defined as the average yearly net book value of fixed assets defined under Russian accounting rules, including real property but excluding land. Starting from 1 January 2014, the tax base for office, retail and multifunctional centres and premises in such centres (with certain exceptions and on the condition that the requirement for the permitted use of the land is satisfied) is determined based on the cadastral value of such centres which is determined and approved by the regional authorities. For foreign legal entities that own immovable property in Russia but do not have a PE in Russia the tax base is determined based on cadastral value. The cadastral value is publicly available in the real estate cadastre.

In Moscow, the tax rate for property with the tax base determined on the basis of its cadastral value is established by regional authorities and is: (i) 1.3% in 2016; (ii) 1.4% in 2017 and (iii) 1.7% in 2018. The tax is payable on annual basis.

Land tax

There is a levy on owners and users of land but lessees of land are exempt from this charge. Land tax is calculated on the basis of so called 'cadastral' value of land defined in accordance with land legislation and the tax rate, which should not exceed 1.5% yearly.

Insurance contributions

- The employer is required to make pay-related contributions to pension, social and medical insurance funds. The rates of the social security contributions for 2016 are as follows: For pension contributions, the rate is 22% of an employee's remuneration up to 796,000 RUB plus 10% of any excess over this cap.

- For social insurance contributions the rate is 2,9% of an employee's remuneration up to 718,000 RUB (the rate is 1.8% of an employee's remuneration in the case of foreign nationals staying temporary in Russia)

- For medical insurance contributions the rate is 5,1% of an employee's remuneration

In addition to insurance contributions to pension, social and medical insurance funds, employers shall pay mandatory accident insurance contributions (AICs) with respect to payments made to employees. The AIC rate ranges from 0.2% to 8.5% of the full amount of remuneration, depending on the level of risk associated with the industry in which the employer operates.

Personal income tax

Individuals are taxed on the proceeds from property sales. With respect to residential property an individual that is a Russian tax resident can either claim a statutory allowance or calculate taxable income as a difference between sale proceeds and documented costs. The statutory allowance with respect to real estate constitutes 1m RUB. If a five-year holding period has expired, the total amount of income is exempt. This exemption does not apply to entrepreneurial income of individuals.

The tax rate is 13% for Russian tax residents. Russian tax residents are individuals that have spent no less than 183 days in Russia in any 12 consecutive months (de facto – not less than 183 days in a given calendar year). Russian-sourced income of individuals that are not Russian tax residents is subject to 30% personal income tax with no deductions or reliefs available.

Stamp duty

Stamp duty for registration of agreements for disposal of immovable property is 15,000 RUB (1,000 RUB for individuals). Stamp duty for notarial certification of residential mortgage contracts is set at 200 RUB and 0.3% of the contract amount for other real estate, but not more than 3,000 RUB. The duty for state registration of agreements on pledge of immovable property, ie, mortgage agreements, and for the issuance of relevant registration documents is established at 2,000 RUB for individuals and 22,000 RUB for legal entities.

Stamp duty is charged on obligatory notarisation of certain deals at the maximum amount of 22,000 RUB.

Regional and municipal taxes in Russia

The Russian tax system generally includes three 'levels' of taxes: federal, regional and municipal. Federal taxes are governed by the federal laws and are effective all over the Russian Federation. Regional taxes are set by the laws of the constituent territories of Russia, based on the provisions of the Tax Code, within the limits established by the Tax Code. Rates may vary from one constituent territory to another. Local taxes are

introduced by the acts of the municipalities based on provisions of the Tax Code, and rates of municipal taxes may also vary from one municipality to another. Moscow and St. Petersburg are separate constituent territories of the Federation, representative authorities (city parliaments) of which set both regional and municipal taxes.

In addition, regional and municipal authorities receive specific portions of federal taxes collected in their constituent territories (municipalities), and may introduce tax incentives in respect of regional (local) portions of some federal taxes within certain limitations.

Contacts

Advisory
Lev Vilyaev
Tel: +7 495 2235703
E-mail: lev.vilyaev@ru.pwc.com

Assurance
Elena Kopanyova
Tel: +7 495 2235037
E-mail: kopanyova.elena@ru.pwc.com

Tax & Legal
Matvey Manuilov
Tel: +7 495 9676039
E-mail: matvey.manuilov@ru.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Singapore

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Singapore 3

Contacts 8

All information used in this content, unless otherwise stated, is up to date as of 12 April 2016.

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
- 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 80% 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% (for accounting period ending in 2009 and onwards) in the case of a company. In the case of individuals, the net rental income is taxable at the rate of 22% (for the year ending in 2016 and onwards) if they are non-resident, and at the tax rate, ranging from 0% to 22% (for the year ending in 2016 and onwards) if they are resident.

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. What defines 'making investments' is a grey area.

Industrial building allowances (IBA) can also be claimed in respect of capital expenditure on the construction or purchase of an industrial building. Office buildings and residential properties do not qualify. An initial allowance of 25% is available, together with an annual allowance of 3% where the building is purchased new. Where it is purchased second-hand, only the annual allowance is available. However, IBA has been phased out with effect from 22 February 2010. With the phase-out, IBA 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, with effect from year of assessment 2006 (accounting periods ending in 2005), 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% unless the shares are scripless. There are no look-through provisions for land rich companies.

Stamp duty is payable on the purchase price of Singaporean immovable property. The stamp duty rates are as follows:

- For the first 180,000 SGD – 1%
- For the next 180,000 SGD – 2%
- For amounts in excess of 360,000 SGD – 3%

Leases with annual rental not exceeding 1,000 SGD are exempt from stamp duty.

Leases with annual rental exceeding 1,000 SGD will be subject to stamp duty as follows:

- Lease period of 4 years or less: 0.4% of total rent for the period of the lease

- Lease period of more than 4 years or for any indefinite term: 0.4% of 4 times the annual rental for the period of the lease

The above is usually borne by the purchaser (ie, a buyer's stamp duty or BSD) unless otherwise agreed between the relevant parties.

For residential property purchases after 8 December 2011, additional buyer stamp duty (ABSD) is payable by the following purchasers at the corresponding rates on the total amount of consideration or value of the property (whichever is higher):

Profile of Buyer	ABSD rates from 8 December 2011 to 11 January 2013	ABSD rates from 12 January 2013
Singapore Citizens (SC) buying second residential property	Not applicable.	7%
SC buying third and subsequent residential property	3%	10%
Singapore Permanent Resident (SPR) buying first residential property	Not applicable	5%
SPR buying second and subsequent residential property	3%	10%
Foreigners*[1] and non-individuals	10%	15%

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 Jan 2013 and sold within three years of acquisition.

[1] Foreigners of certain nationalities who fall within the scope of respective Free Trade Agreements will be accorded same treatment as Singapore citizens.

The current applicable SSD rates are as follows:

Holding period	SSD Rate Residential property	SSD Rate Industrial property
Up to 1 year	16%	15%
More than 1 year and up to 2 years	12%	10%
More than 2 years and up to 3 years	8%	5%
More than 3 years and up to 4 years	4%	NA

Goods and Services Tax (GST)

GST, which is currently at 7%, is payable on the acquisition cost of commercial 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 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[2], the property tax rate is a progressive rate from 10% to 20% (from 1 January 2015 onwards).

[2] 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.

Contacts

Advisory

Yong Jiunn Siong
Tel: +65 6236 7238
E-mail: jiunn.siong.yong@sg.pwc.com

Lie Kok Keong
Tel: +65 6236 7288
E-mail: kok.keong.lie@sg.pwc.com

Assurance

Yeow Chee Keong
Tel: +65 6236 7298
E-mail: chee.keong.yeow@sg.pwc.com

Choo Eng Beng
Tel: +65 6236 3848
E-mail: eng.beng.choo@sg.pwc.com

Tax

Teo Wee Hwee
Tel: +65 6236 7618
E-mail: wee.hwee.teo@sg.pwc.com

Ng Wei Pheng
Tel: +65 6236 3663
E-mail: wei.pheng.ng@sg.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Slovakia

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary - Slovakia 3

Real Estate Investments - Slovakia 5

Contacts 13

All information used in this content, unless otherwise stated, is up to date as of 18 May 2016.

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, which is 22%. 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, €35,022.31) 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, is 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 it is agreed in rental agreement in writing and 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.

Real estate transfer tax

Real estate transfer tax was fully abolished for transactions taking place on or after 1 January 2005.

Real Estate Investments - Slovakia

Direct investments in Slovak estate

Legal aspects

Ownership

Ownership of a property is a right to possess, enjoy, use and dispose with the property within the limits of the legal regulations.

Unlike in some other countries, in **Slovakia the legal principle** '*superficies solo cedit*" does not apply, ie, the ownership of land and building may be split. Thus, the building and the land may belong to different owners.

In general, ownership of a real estate is governed by Slovak Civil Code, Cadastral Act and by Act on Ownership of Residential and Non-Residential Premises as a special law, governing the ownership of residential and non-residential premises.

Co-ownership

Property may be owned by two or more co-owners. In that case, the ownership is split into co-ownership shares according to the participation of co-ownership types. These are (i) common co-ownership, where the shares are exactly determinable; and (ii) community co=ownership of spouses, which applies only for married couples, and shares are not determinable, as the whole property of spouses is owned jointly and inseparably. 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 reservation agreement (RA) or 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 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).

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.

Pre-completion formalities

Real estate purchase agreement

Apart from the general contractual requirements as specified above and the purchase price, the real estate purchase agreement must contain the following essentialities:

- 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, determination of the size of co-owner share.

Land Cadastre

Once the agreement(s) have been executed, the following pre-completion formalities will be carried out:

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:

- 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;
- 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;
- 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;
- 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 authorized 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 acquisitions costs, with the few exceptions set out by the law.

The contractual parties may agree on different regime of the 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 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.

In case of individual owning property in Slovakia the type of deductible expenses depends on the treatment of property. In particular,

- if property treated as non-business asset, only monthly utility expenses can be deducted (eg, gas, electricity).

- if property treated as business asset, various expenses can be deducted (eg, Slovak tax depreciation, utilities, maintenance fees, repairs, mortgage interest). At the same time tax summary evidence will be required in this option.

Also, the first €500 (for 2016) 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.

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 22%. 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. The tax base of up to 176.8 times the subsistence level (ie, €35,022.31) is subject to a 19% tax rate. The exceeding part of the tax base is taxed at 25%.

Business combinations

There are the following alternatives for the business combinations:

1) Sale of business as a going concern (further as "BGC").

2) Contribution of the BGC to share capital.

3) Sale of individual assets and liabilities.

4) Contribution of individual assets to share capital.

5) Mergers and demergers.

Application of alternatives 2, 4 and 5 may be done in a tax neutral way immediately, application of options 1 and 3 can theoretically be tax neutral over the time.

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)

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 for use for the first time. However, the transferor 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.

The period for adjustment of the input VAT deduction on immovable property, in the case of change of its intended use, is either 10 or 20 years depending on certain criteria. The period for archiving invoices received in relation to such immovable property is also extended to 20 years.

With effect from 1 October 2012, the supply of real estate or part of real estate in Slovakia, which the Seller opted to tax should be 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.

As of 1 January 2016, local reverse-charge mechanism applies in case of supply of

construction works; supply of building or parts of buildings under the framework of the construction or similar agreements; supply of 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 it is 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.

A tax securement of 19% applies to rent and sales price paid by a Slovak entity or individual to a non-EEA entity/ individual for real estate located in Slovakia. A 35% securement tax rate applies on payments to taxpayers from "non-contracting states" (ie, states that did not either conclude a double tax treaty or tax information exchange agreement with the Slovak Republic).

No tax securement is required for rental payments to EEA-resident entities.

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 (ie, income less tax-deductible costs attributable to earning the income under Slovak tax law). If the tax return is not filed, the tax authorities can consider the tax securement to be a final tax.

The gain from disposal of shares in a Slovak company is generally subject to 22% corporate income tax if purchased by a Slovak taxpayer. In case the shares of the Slovak

company are sold by a foreign tax resident to another foreign tax resident, the gain is subject to taxation only if the seller is residing in a non-EU country or the Slovak entity is a real estate company (ie, company owning Slovak immovable property with book value higher than 50% of its equity). Even in this case, an applicable double tax treaty will often provide protection from taxation in Slovakia.

There is no withholding tax on dividends paid by Slovak entities out of profits arising in 2004 and subsequent years.

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). 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 19%/35% (in case of taxpayers from non-contracting states) 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 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.

For issues related to the interim provision regarding tax losses carried forward from years 2010 to 2013, please contact PwC Slovakia (see section '*Contacts*' below).

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. Under the Slovak Act on Local Taxes the basic annual tax rate for **tax on apartments is €**0.033 per square metre of the floor area of the apartment. However, the tax rates are normally changed by the municipality issuing a General Binding Regulation on a yearly basis.

Contacts

Advisory

Alexander Šrank
Tel: +421 259 350587
E-mail: alexander.srank@sk.pwc.com

Assurance

Alexander Šrank
Tel: +421 259 350587
E-mail: alexander.srank@sk.pwc.com

Tax

Margaréta Bošková
Tel: +421 259 350611
E-mail: margareta.boskova@sk.pwc.com

Legal

Martin Javorček
Tel: + 421 903 359799
E-mail: martin.javorcek@sk.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
South Africa

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – South Africa 3

Contacts 17

All information used in this content, unless otherwise stated, is up to date as of 22 April 2016.

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 15% 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 *'Thin capitalisation'* 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 15% 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 41% apply. For the 2016/17 tax year ending on 28 February 2017, the highest rate of 41% applies to taxable income in excess of 701,300 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. In such a case, the deduction is limited to an amount determined in accordance with a formula which limits the deduction to a percentage of adjusted taxable income (essentially a tax EBITDA).

Cost of obtaining finance

Costs of obtaining finance, including legal costs and securities transfer tax, are normally regarded as being of a capital nature and so not tax-deductible. Interest, however, is normally deductible. The raising fees are in most cases treated in the same way as interest.

Depreciation and building capital allowances

Depreciation and building capital allowances used to be available only if the buildings were used in the industries of manufacturing, provision of residential accommodation, hotel keeping, farming, mining, or in terms of special urban renewal projects, provided certain requirements were met. From 1 April 2007, the depreciation allowance was extended to all other commercial buildings as well. In addition, allowances have been introduced for buildings used in research and development (R&D) activities and for airport and port buildings.

Deductions in respect of manufacturing buildings

The write-off rate for manufacturing buildings and improvements thereto depends on the date when the construction of the building or the improvement commenced, as shown below:

Date when the building was erected	Before 01/01/1989	On or after 01/01/1989
Annual write-off rate	2%	5%

The building must, during the relevant year of assessment, 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 SARS requires that the building must be used at least 50% for 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:

Before 4 June 1988	2%
From 4 June 1988 onwards	5%
From 17 March 1993, in respect of improvements that do not extend the exterior structure of the building	20%

The annual allowance granted in respect of the building or improvements is limited to the cost of the building or improvements.

The annual allowance may be recouped when the building is sold, or the recoupment may be set-off against the cost of a further building, if the taxpayer purchases or erects a building within 12 months or any further period which the Commissioner may allow. The new building must in itself meet the requirements to qualify for the allowance.

Deductions in respect of plant and equipment

Certain limited components of buildings may be considered to be plant and equipment. These are generally depreciable for tax purposes over their useful lives. Qualifying items include air conditioning, with a write-off period of 6 years (the recommended write-off periods for air-conditioning acquisitions on or after 1 March 2009 are 6 years for a window type, 5 years for a mobile unit and 10 years for a room unit), lifts, with a write-off period of 12 years, and demountable partitions, with a write-off period of 6 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 s**olely 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 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, 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:

- Immoveable property situated in SA **held by that person, or any 'interest' or rights** of whatever nature of that person to, or in immovable property situated in SA.
- **An 'interest in immoveable property' situated in S**A includes an interest of at least 20% held by a person (alone or together with a connected person), in the equity of a company, or in any other entity, if, at the time of disposal, 80% or more of the market value of such shares or interest is directly or indirectly attributable to immoveable property situated in SA. This excludes immoveable property held by a company or other entity as trading stock.
- Any asset that is attributable to a permanent establishment of that person in SA.

A capital gain arises where the proceeds received for the disposal of the asset exceeds the base cost of the asset. Special inclusions and exclusions exist for both the determination of the base cost and proceeds in respect of such assets. Generally the base cost includes the direct cost of acquisition of the immoveable property as well as certain indirect costs such as valuation fees, consulting, legal, accounting or agent fees, transfer duty and advertising costs. These indirect costs extend to both the acquisition and disposal of the asset.

Net capital gains are included in the taxable income of a taxpayer at the following inclusion rates, for years of assessment ending prior to 1 March 2016:

- 33.3% for individuals and special trusts (ie, trusts formed to benefit a minor child, or a physically or mentally handicapped person).
- 66.6% for all other taxpayers, including companies and other trusts.

The effective CGT rates for years of assessment ending prior to 1 March 2016 are as follows for the following entities:

Type of taxpayer	Inclusion rate (%)	Statutory rate (%)	Effective rate (%)
Individuals	33.3	0–40	0–13.3
Individuals (01/03/2015 until 29/02/2016)	33.3	0-41	0-13.7
Trusts	66.6	40	26.7
Companies	66.6	28	18.6
Permanent establishments (branches)	66.6	28	18.6

For years of assessment commencing on or after 1 March 2016 the effective CGT rates are as follows:

Type of taxpayer	Inclusion rate (%)	Statutory rate (%)	Effective rate (%)
Individuals/ Special Trusts	40	0–41	0–16.4
Other Trusts	80	41	32.8
Companies	80	28	22.4
Permanent establishments (branches)	80	28	22.4

Gains realised on the sale of property are generally subject to CGT. Certain exemptions, however, exist in this regard, eg, an exemption of the gains from the sale of the property used as a primary residence to the limit of 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 15% 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/value-added tax (VAT)

The acquisition of legal title to a property in SA is subject to a real estate transfer duty.

Currently, the rate for all persons is on a sliding scale:

Value of property (ZAR)	Rate
0 - 750,000	0%
750,001 – 1,250,000	3% on the value above 750,000 ZAR
1,250,001 – 1,750,000	15,000 ZAR + 6% on the value > 1,250,000 ZAR
1,750,001 – 2,250,000	45,000 ZAR + 8% on the value > 1,750,000 ZAR
2,250,001 – 10m	85,000 ZAR + 11% on the value > 2,250,000 ZAR
>10m	937,500 ZAR + 13% on the value > 10m ZAR

Taxpayers engaged in corporate reorganisation transactions as envisaged in the Income Tax Act (eg, asset-for-share transactions, amalgamation transactions, intra-group transactions etc) will obtain relief from transfer duty.

If the seller is a registered VAT vendor, VAT is levied on the transaction at a rate of 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%, 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 immoveable property from a non-resident must withhold a percentage of the purchase price and pay it over to SARS, if the purchase price of the property exceeds 2m ZAR. The withholding constitutes 5% of the purchase price if the seller is an individual, 7.5% if the seller is a company and 10% 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.

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 formalized 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 16.4%. 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 41%.

Contacts

Advisory
Tertius van Dijk
Tel: +27 21 5292563
E-mail: tertius.van.dijk@za.pwc.com

Assurance
Alsue du Preez
Tel: +27 11 797 75609
E-mail: alsue.du.preez@za.pwc.com

Tax & Legal
Kyle Mandy
Tel: +27 11 7974977
E-mail: kyle.mandy@za.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Spain

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Spain 3

Real Estate Investments – Spain 6

Contacts 36

All information used in this content, unless otherwise stated, is up to date as of 25 May 2016.

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. Financial expenses disallowed 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.

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 10%, 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% 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 1.10%, applicable to the cadastral value of urban properties, and 0.3% to 0.9%, applicable to the cadastral value of non-urban properties. Such a rate is increased or decreased by the local authorities, depending on the specific location of the property. The taxpayer is the owner of the real estate. Real estate tax is deductible for corporate tax purposes.

Tax on increase of value of urban land

A tax on the increase of the value of urban land will accrue upon the transfer of urban land. The taxpayer is the seller. It is a deductible expense for corporate tax purposes.

Tax on construction, installation and building projects

A tax levied on construction, installation and building projects applies to the effective cost of the work. The taxpayer is the owner of the construction work, not necessarily the owner of the building. It is a deductible expense for corporate tax purposes.

The maximum tax rate will be 4%, depending on the municipality in which the works are carried out.

Real Estate Investments – Spain

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 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, 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 activities.

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.

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 to the 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 (*division en propiedad horizontal*). Under this regime, 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 concessionee 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*).

  - An opening or operating licence (*Licencia de Apertura o Funcionamiento*).

Licences are regulated by regional regulations (*normativa autonómica*) and finally, municipal regulations (*normativa municipal*). According to those regulations, the regimen of the licences can change. It has to be taken into account that the licences are granted by the town hall authorities. This means that the process to obtain the licences may vary in the different municipalities regarding term, resolution, documentation requested, etc.

Tax environment

This section analyses the general principles governing Spanish taxation of real estate investments. In this respect, it should be noted that the analysis of the particular tax provisions that might be applicable in the different Spanish autonomous communities, and especially in the Basque Country, Navarra and the Canary Islands, are outside of the scope of this brochure.

The scope of Spanish taxation

Under Spanish domestic law, income and capital gains triggered by Spanish real estate properties are taxable in Spain, whether realised by a Spanish resident or non-resident. Moreover, Spanish law provides for the taxation in Spain of capital gains stemming from the sale, by a non-resident, of the shares of a company, whether or not Spanish, whose principal assets consist of Spanish properties.

The application of these provisions to non-residents depends on the contents of the tax treaty that binds Spain and the country of residence of the owner of the properties or shares of real estate companies.

Most of the tax treaties concluded by Spain stipulate, according to article 6 of the OECD Model Convention, that real estate income is taxable in the country where the property is located. Yet, only through a case-by-case analysis will it be possible to determine whether Spain has the right to tax or not.

Income/capital gains tax

There are no separate taxes for income and capital gains in Spain.

Resident entities

Spanish resident entities are subject to Spanish corporate tax on their worldwide net income and capital gains.

Taxable income generated by resident companies is subject, as a general rule, to a flat corporate tax rate of 25%.

For corporate tax purposes, the starting point to determine taxable net income and capital gains is the company's annual accounts. Nevertheless, adjustments are normally required in order to bring the annual accounts figures in line with tax rules.

Rules governing the accounting results are contained in the Commercial Code, Corporations Act and in the General Accounting Plan. New Spanish GAAP rules came into effect as of January 2008.

Net income is generally determined on an accrual basis, ie, income has to be attributed to the year to which it economically pertains.

Spanish tax regulation requires that transactions carried out between related parties comply with arm's length principles. Transfer pricing regulations oblige taxpayers directly to price their intercompany operations at arm's length and impose the obligation to make available to the tax administration, documentation that justifies the prices applied. All domestic and international transactions between related entities must be valued at arm's length for tax purposes and be duly documented.

Corporate tax returns must be filed annually, within 25 calendar days following the six months subsequent to the end of the tax period.

Corporate tax must be paid on a prepayment basis at periodical intervals throughout the financial year.

Joint ventures (*Unión Temporal de Empresas*, or UTEs)

Joint ventures are especially used by construction and engineering companies when a contract is given to more than one company. They are treated as Temporary Consortia

companies, not paying corporate tax on the part of taxable income imputable to the member resident company. However, this tax regime will not be applicable to the portion of the taxable base of the joint venture attributable to non-resident members. This taxable base is taxed at the general tax rate of the corporate income tax, ie, 25%.

Community of owners and civil partnerships

Income corresponding to communities of owners and partnerships that carry on business activities as entrepreneurs will be attributed to common owners or participants, respectively, in accordance with the rules or agreements applicable in each case.

These are forms used to develop real estate activities in Spain in order to avoid the tax and administrative costs of incorporating a company. Notwithstanding the above, special care regarding the liability regime applicable to the members of these forms must be considered. Both of them are regarded as VAT taxpayers.

Participatory account contract (*contrato de cuentas en participación*)

This is a type of legal contract whereby an owner of land transfers, or merely allows an entrepreneur named as a management participant, normally the constructor, to use the land. As consideration for such use, the management participant must pay a portion of the profits obtained in the developing of the real estate promotion, or in the business carried out on the land, to the non-management participant.

The remuneration paid by the management participant to the non-management participant, ie, the owner of the land transferred or contracted to the management participant, is tax-deductible for corporate tax purposes.

Resident individuals

Resident individuals are subject to Spanish personal income tax on their worldwide income.

Trusts are not specifically recognised under Spanish law.

The personal income tax base shall be taxed at the progressive rates stated in the state **and autonomous communities' scales with a marginal tax** rate of 45%. Nevertheless, capital gains generated are subject to the following tax rates (in tranches): 19% for gains up to €6,000, 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.

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 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 10%, 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.
- 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

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

With the pre-contract known as the purchase option, 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 the said property.

The fact of the beneficiary accepting the promise by signing such a preliminary contract does not in any way represent an undertaking to buy. The beneficiary simply acknowledges the promise of the seller, the only party bound by the contract.

When the beneficiary exercises the option to buy, the sale is completed. Failing this, the seller is released from their promise, and is free to sell the premises to a party other than the beneficiary.

There can be an option price fixed by mutual agreement between the parties.

The purchase option will be enforceable *vis-à-vis* third parties if it is duly recorded at the Land Registry. For such recording, the requirements according to the Mortgages Act are as follows:

- Mutual agreement between the parties in relation with the recording.

- The Price for the acquisition of the premises and, if any, the price established for the option.
- 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 *Ministerio de Economía y Hacienda*, once they have 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. In any event that 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 21%.
- Buildings still in construction, at 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 a 21% rate.
- Transfers of buildings for rehabilitation, at 21%.
- Transfers of buildings to be demolished, in order to carry out a new real estate promotion, at 21%.
- Transfers of purchase options on real estate, at 21%.
- Transfers of a ground lease right, at 21%.

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 10%, 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 stock 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 regime 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, or *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 previewed 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 limited companies *(Sociedades Anónimas)*, which have as principal purpose 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 fulfil the legal requirements regarding the investment policy. Once this transitory period is completed, all the requirements regarding the investments in urban real estate must be fully completed or, if this is not the case, the entity could lose its legal consideration as a collective investment institution.

The applicable Spanish regulations concerning investments managed by these real estate investment institutions provide for several additional requirements to be observed during the transitory period. These requirements relate to such areas as type of eligible financial instruments and diversification rules.

Investment regime

Real estate collective investment institutions must invest in urban real estate to be leased such as dwellings, offices, commercial facilities, or students' and elderly residences. In addition, these institutions can invest in real estate in construction phase, options, or real rights over real estate and administrative concessions that allow for the lease of real estate.

Real estate investment companies and real estate investment funds must invest at least 80% and 70% (respectively) of their total assets in real estate. The rest of their assets can be invested in certain type of listed securities.

Real estate investment funds must maintain a minimum 10% liquidity ratio over the total assets of the previous month shall be maintained in those months were unitholders of real estate investment funds have a redemption right.

With each type of institution, no single property can represent more than 35% of the institution's total assets (calculated at the time of its acquisition).

Properties that make up the assets of these entities cannot be sold during a three-year holding period, unless express authorisation of the CNMV is granted.

These entities can only carry out certain real estate promotions.

The borrowed funds of collective investment institutions cannot exceed 50% of the institution's total assets.

Restrictions on operations with directors, administrators, managers, participants and partners of these institutions

Restrictions exist relating to the purchase, sale or lease of the assets of real estate investment companies and real estate investment funds to their directors, managers, participants and partners. In addition, restrictions exist relating to the acquisition by these institutions of properties from companies of the same group, or which form part of the group of the management company.

Inspection and supervision

The CNMV shall inspect and supervise collective investment institutions to make certain they fulfil all 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, but 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 corporation (*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.

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 obliged 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 3 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 (28% in 2015, 25% in 2016) 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 (28% in 2015, 25% in 2016) 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 2 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 to 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 real and voluntary guaranty that guarantees the payment of a specific credit. The mortgage has to be duly drafted before a public officer 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

The participating loans may be considered a variety of subordinated loans, which are those by virtue of which the creditor expressly waives their priority in rank for the benefit of other creditors. Participating 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 participation loans must necessarily have the following features:

- The loans must provide to the investor 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 must 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 must exist an obligation that the borrower repay to the investor the funds granted, in order to determine the loan's nature as debt and not as equity.

In the case of profit participation 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 mercantile 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, Supervision 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 rents 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.
- 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.
- 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 1.10%, 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 certain circumstances, as described below.

- 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. It requires two elements: title (contract, public deed, etc) and the transfer of possession (modo) that can be made in a symbolic way. Granting the transfer in public deed implies the transfer of ownership unless parties agree on the contrary.

Registration within the Land Registry is not compulsory but mostly 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, ie, the calendar year in which the property is put into use and the subsequent nine calendar years. In the year in which the property is put into use, the VAT will in principle be recoverable according to the ratio between the turnover from VAT-able supplies and the total turnover of the taxpayer.

At the end of each following year a comparison must be made between that year's ratio and the ratio of the acquisition year. If the ratios differ, either additional VAT payment must be made, or a VAT refund will be received by the owner of the property. However, if the ratios differ by 10% or less, no additional payments will be made. When property is transferred during the revision period, a VAT adjustment may be required. For that purpose, 10% of the original VAT paid is notionally allocated to each year of the revision period.

Regarding the VAT consequences of the transfer of the property during the revision period, the following rules apply.

- If the transfer is not subject to VAT (with the exception of the transfer of a going concern), then a legal fiction assumes that the property has only been used by the seller for tax-exempt activities during the remaining part of the revision period. The input VAT, at an amount of 10% per year, allocated to this remaining period, cannot be recovered by the seller. If this VAT has already been recovered by the seller in previous years, a one-time adjustment payment must be made by the seller to the tax authorities for the remaining part of the ten-year period.

- If the transfer is subject to VAT, then a legal fiction assumes that the property has been used by the seller for taxable activities during the remaining part of the revision period. The input VAT, at an amount of 10% per year, allocated to this period can be fully recovered by the seller.

Regarding the ten-year revision period, a new computing will start for the buyer of the property, following the VAT-able transfer of a property.

Municipal tax on increase in value of urban land

This local tax will accrue upon the transfer of urban land. The taxpayer is the seller. The economic consequences of this tax could be relevant, depending on the date of acquisition of the land transferred.

The maximum tax rate will be 30%, depending on the municipality where the real estate is located. This tax rate is applicable on the deemed increase in value calculated on the cadastral value of the land taking into account the coefficients included in the tax ordinances. The tax on increase of value of urban land is deductible for corporate tax purposes.

Sale of shares in Spanish resident entities

Under Spanish domestic legislation, capital gains obtained by non-residents from the disposal of shares of Spanish companies for which their main assets consist of real estate are taxable in Spain at a 19% rate. However, under certain tax treaties such taxation can be avoided.

Conclusion

As in any other investment, the fixing of an optimal investment structure for real estate acquisition, exploitation or transfer will depend on the specific objectives of each investor.

Before investing in Spanish real estate, it is highly advisable for the investor to check the burdens on the property, and whether it is eligible for the use towards which it is intended.

Obviously, the optimal solution might vary from passive to active investments, from long-term to short-term expectations, or even depending on the residence of the investor or the financial tools available.

Apart from direct taxation considerations, some other very different aspects should be borne in mind prior to investing in Spanish property, such as the following:

- VAT recovery.
- Possibility of option to VAT if VAT exempted.
- Transfer tax.
- Taxation on share deals, when acquiring or transferring.
- Financial expenses capping rule.
- Transfer pricing.
- Repatriation of funds.

Contacts

Advisory

Guillermo Massó López
Tel: +34 91 568-4353
E-mail: guillermo.masso@es.pwc.com

Assurance

Gonzalo Sanjurjo
Tel: +34 91 568-4989
E-mail: gonzalo.sanjurjo.pose@es.pwc.com

Tax

Antonio Sánchez
Tel: +34 91 568-5615
E-mail: antonio.sanchez.recio@es.pwc.com

Carlos Bravo
Tel: +34 91 568-4956
E-mail: carlos.bravo.gutierrez@es.pwc.com

Legal

Javier García Camacho
Tel: +34 91 568-4209
E-mail: javier.garcia.camacho@es.pwc.com

Paula Hernández Lemes
Tel: +34 91 568-4290
E-mail: paula.hernandez.lemes@es.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Sweden

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents ... 2

Real Estate Tax Summary – Sweden ... 3

Real Estate Investments – Sweden ... 9

Contacts ... 13

All information used in this content, unless otherwise stated, is up to date as of 9 May 2016.

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%. 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 no thin capitalisation rules in Sweden. However, Sweden has imposed interest stripping limitations as of 1 January 2013. During spring 2014 a draft proposal for new interest stripping rules was presented. The proposal was heavily criticised and no new interest stripping rules are expected to be implemented before 1 January 2017. Please see section '*Interest stripping limitation*' 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 ingoing balance of the reserve each year. The government borrowing rate at the end of November 2015 was 0.65%.

Interest stripping limitation

The first regulations limiting interest deduction were introduced 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, whatever 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). However, 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 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.

In line with the current rules, the scope-extension to any internal loan, whatever its purpose, might drastically increase the applicability of these restrictions, to not only loans for debt push-downs (internal share transfers), but also to external acquisitions of shares, as well as regular financing for acquisition of businesses or assets, or just for cash needs. As the new restrictions apply for interest accruing in 2013, they may also affect existing loans.

On 2 December 2014, the European Commission issued a formal notification to the Swedish government as they are of the opinion that – based on earlier discussion with the Swedish government - the rules might not be compliant with EU-regulation.

On 20 February 2015, the Swedish government replied, maintaining the opinion that the Swedish interest stripping rules are compliant with EU-regulations. The matter is at the moment in the hands of the European Commission. The Commission can either end the complaint or send the Swedish government a motivated notification demanding a change to the legislation. As a final step, the Commission may forward the

issue to the EU-Court for final assessment. **Also, as indicated under section "Changes to tax law" Sweden is likely to face additional changes with respect** to the ability to deduct interest cost.

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.

Withholding tax

There is no withholding tax on interest in Sweden and there is no withholding tax or branch profits tax applicable to PEs operating in Sweden. Dividends distributed by a resident company to a foreign company are, in short, exempt from withholding tax, if the latter company would be exempt from taxation on a received dividend would it 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 being liable to tax in a similar manner as a Swedish company. Should a company not qualify for the exemption, a 30% withholding tax applies. However the withholding tax rate can be reduced according to a double tax treaty concluded between Sweden and the other country.

As of 1 January 2016, there has been some updates to one of the rules in the Swedish Withholding Tax Act. The relevant rule aims to prevent situations where an entity formally holds the shares in a company at the time of the dividends distribution (instead of the real "beneficial owner" of the dividends), in order to reduce or avoid withholding tax. The rule has now been adjusted in a way that it is also clearly stated that dividends distributions that explicitly are tax exempt according to the Withholding Tax Act, may fall within the scope of this rule (eg, in situations where the company receiving the dividends is covered by the EU Parent-/Subsidiary Directive).

As of 1 January 2016, the scope for advanced rulings from the Swedish Board of Advanced Rulings has also been extended to include inquiries regarding withholding tax.

Real estate transfer tax

A direct acquisition of the legal title to Swedish property is, for legal entities, subject to 4.25% real estate transfer tax. The basis of the transfer tax shall be constituted by the higher of the purchase price and the tax assessment value of the real property 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, ie, 1 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 eg, include certain information regarding the investments made on the property during the past ten years and information regarding the seller and the buyer.

Adjustments of input VAT should be made if the use of premises where an investment has been made, changes from VATable to non-VATable or vice versa. The VAT adjustment could as a result either imply that the owner of the property is granted additional deductions of VAT or that the owner of the property is liable to repay previously recovered input VAT.

Input VAT attributable to the purchase of a property could as a result be recovered to the extent the property is used in a VATable business. Regarding input VAT pertaining to costs incurred in the process of purchasing a property company, recovery could be possible provided that the acquired company will be part of the buyer’s VATable business. The right to deduct input VAT on transaction costs is currently under scrutiny by the Tax Agency.

The Swedish Supreme Administrative Court ruled (27 April 2011) that real estate broker’s services are VAT-exempt when property is sold via a corporation, the reason being that the services supplied are relating 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 being that the real estate broker's services are relating to sale of real estate, which is VAT-exempt.

Other relevant taxes

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 1.0% for commercial office space and 0.5% for industrial property. The annual property tax on properties for residential purposes is 1,268 SEK/flat for financial year 2016 maximised to 0.3% of the assessment value. Should one property consist 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

In 2013 the so called Corporate Tax Committee was commissioned to, among others, make the tax provisions more equal when financing with equity and loaned capital. The main proposal released in 2014 was that no deduction is granted for negative net financial expenses. As an alternative rule, interest deduction limitations could instead be based on a so-called EBIT-model (Earnings Before Interest and Tax). Both proposals entail that financial expenses may be fully deductible against corresponding revenues.

The proposal has received extensive criticism, especially with regards to what is applicable to financial costs. Strong criticism has also been conveyed against the effects of the proposal on the property sector. Overall, most of the respondents objected to both models in their proposed form.

The Finance Minister has expressed that none of the models should be implemented without a thorough analysis. Since an increase in new constructions is a high priority for the government, the consequences for the property sector must also be carefully analyzed.

Considering the above and also the on-going BEPS (Base Erosion and Profit Shifting) and ATAP (EU's Anti Tax Avoidance Package) projects, which both suggest interest deduction limitations based on an EBITDA-model, there are reasons to believe that the Corporate Tax Committee are looking into the already proposed alternative rule further.

The fundament of the alternative rule – as presented back in 2014 – was to cap the deduction of a negative financial expense at 20% of the EBIT for tax purposes. To what extent there will be amendments to this proposal has not been presented. It has however been stated that a new proposal will not enter into force prior to 1 January 2017.

Tax exempt transfers of real estate

On 11 June 2015, the Government decided to assign an investigator to review whether the tax rules specifically favour certain businesses or certain companies within the same line of business. The investigation will also assess the national economic impact of tax neutral transfer of properties and review certain issues within the real estate and stamp duty area.

The commissioned group will, *inter alia:*

- identify and analyse the overall tax position of companies in the real estate business (both tax rules and tax burden),
- in particular, identify and analyse the prevalence of tax neutral transfer of properties as a tool for tax planning, as well as from a national economic perspective analyse the effects of the ability or lack of ability to tax neutral transfers of properties,
- propose changes of the current legislation to prevent tax neutral transfers of properties as a tax planning tool, and,
- analyse whether acquisitions through land amalgamation/re-allotment of properties is misused to avoid stamp duty and, if appropriate, propose constitutional amendments.

It is at this stage uncertain whether share deals in which the transferred company has held the property for a longer period may also become affected by potential suggested amendments to the law.

The committee should issue the report on 31 March 2017.

Harmonised VAT definition of real properties

As an implication of the changes in the Council Implementing Regulations (EU) No 282/2011 of 15 March 2011 the Swedish definition of real properties will have to be changed in terms of VAT taxation. The purpose is to have a harmonized definition of real properties within the European Union. The changes are suggested to come into effect as of 1 January 2017.

Real Estate Investments – Sweden

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 minimum share capital of 50,000 SEK. The AB is taxable on its corporate income at 22%. 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.

An HB and a 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 an HB is a partnership with joint and several liabilities between the partners. Both types of partnerships are hereinafter referred to as "HB".

An 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 an 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 an 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 is 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.

As of 1 January 2016 dividends from a foreign entity are not tax exempt if the dividend gives right to a tax deduction as an interest cost or similar for the paying entity in the other country.

Dividends distributed by a resident company to a foreign company are exempt from withholding tax; if the latter company would be exempt from taxation on a received dividend would it have been a company resident in Sweden. This requires that the foreign company can be regarded as having the same characteristics as a Swedish company, both in respect of the legal characteristics, eg, such as limited liability for the shareholders, as well being liable to tax in a similar manner as a Swedish company.

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 permanent establishment (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.

As previously presented in the chapter, "*Changes to tax law*", there is an ongoing investigation with the focus on finding out whether companies within a specific line of business are favourable from a tax point of view, especially focusing on tax neutral transfer of properties and issues within the real estate and stamp duty area. The investigation could have an impact on the real estate business.

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

Direct acquisition of legal title to Swedish property is, for legal entities, subject to 4.25% real estate transfer tax. The basis of the transfer tax 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. Sale of shares in a real property company/partnership is not subject to transfer tax.

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%. 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

There is no withholding tax 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%, 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.

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, 1 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.

Contacts

Advisory (Corporate Finance)

Johan Björk
Tel: +46 10 2133953
E-mail: johan.bjork@se.pwc.com

Daniel Fornbrandt
Tel: +46 10 2133782
E-mail: daniel.fornbrandt@se.pwc.com

Assurance

Susanne Westman
Tel: +46 10 2133296
E-mail: susanne.westman@se.pwc.com

Helena Ehrenborg
Tel: +46 10 2133308
E-mail: helena.ehrenborg@se.pwc.com

Tax & Legal

Katarina Menzel
Tel: +46 10 2124792
E-mail: katarina.menzel@se.pwc.com

Peter Lindstrand
Tel: +46 10 2133197
E-mail: peter.lindstrand@se.pwc.com

Knut Fogelfors
Tel: + 46 10 2133396
E-Mail: knut.fogelfors@se.pwc.com

Christian Jensen *(VAT)*
Tel: +46 10 2126451
E-mail: christian.jensen@se.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Switzerland

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents ... 2

Real Estate Tax Summary – Switzerland ... 3

Real Estate Investments – Switzerland ... 5

Contacts ... 18

All information used in this content, unless otherwise stated, is up to date as of 14 April 2016.

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 guidelines.

Depreciation

Maximum depreciation rates allowed for tax purposes are issued by the Swiss Federal Tax Administration. There are different rates for commercial buildings, office and bank buildings as well as department stores. Higher depreciation is allowed for tax purposes if the taxpayer can prove that such depreciation is required from a statutory accounting perspective. Some cantons follow the federal guidelines, whereas some cantons apply their own (more liberal) applicable depreciation rates.

Property taxes/capital gain taxation

With regard to the ownership and the transfer of real estate property in Switzerland property taxes may apply. Dependent on the location of the real estate property, ownership related property taxes are levied at the cantonal and/or communal level or do not exist at all.

In the case of the sale of real estate property, real estate transfer tax and taxes on the capital gain may apply.

At federal level, the capital gain realised on real estate held as business assets is subject to ordinary income tax. At cantonal and communal level, the capital gain realised is either subject to the ordinary income tax (dualistic method) or subject to the real estate capital gain tax (monistic method).

Real Estate Investments – *Switzerland*

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 special kind of the collective ownership, whereas the building is divided into special parts for the exclusive usage of the specific condominium owner. The building itself is registered in the land register, and every condominium with its quota and owner is recorded separately on a different page of the register as well. Each condominium has its own access and separate arrangements such as garages, cellars, etc. In the condominium owners' meeting, the

owners meet to discuss expenditures and maintenance issues. The voting powers of the owners depend on the quota they possess. Every part can be sold individually, but it is common to agree on a pre-emption right in favour of all other condominium owners.

Joint ownership

Real estate can finally be held in joint ownership (*Gesamteigentum*), where several persons are bound together into a community either by legal provisions (eg, community of property between spouses, family members, heirs) or by contract (eg, ordinary, general or limited partnership). The rights of each joint owner are attached to the whole object and no independent percentage or quota is defined or recorded in the land register. The disposal of a jointly owned object requires the consent of all owners.

Restrictions of ownership

Ownership rights can be restricted by law or by contract. In the case of direct restrictions, the law obliges the owner to tolerate, refrain or act in a certain way. No special private or official order is required and the restriction does not need to be filed with the land register. Such direct restrictions include, for example, construction law provisions (eg, minimal distance from the property line to a building or maximal height of a building) and neighbour law provisions. Indirect restrictions originate from public and private law. They entitle the beneficiary to a claim towards the land owner 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 least 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 part 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 not be granted), if each of the following conditions is 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 real estate transaction is a 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);
- The real estate transaction is not exempted from the authorisation requirement (eg, subsidised housing).
- The transaction is not captured by the free quota in one of Switzerland's tourist region.

Definition of foreigners

The following individuals are deemed foreigners within the meaning of the Lex Koller:

- Foreigners domiciled abroad;
- Foreigners domiciled in Switzerland, except such persons holding a valid C settlement permit, or citizens of a Member State of the European Union (EU) or the European Free Trade Association (EFTA) and holding a valid EU/EFTA settlement or residence permit (B, C or L permit).

Legal entities and partnerships qualify foreigners if:

- They have their registered offices abroad (even if they are controlled by non-foreigners or Swiss citizens); or
- They are domiciled in Switzerland but controlled by foreigners. Control is deemed to exist if more than one third of the share capital or the voting rights is owned by foreigners or if material loans are granted by foreigners.

No authorisation for commercial properties

With respect to the object of the transaction, it is important to note that commercial properties are exempted from the Lex Koller. Hence, a foreign investor is allowed to acquire real estate in Switzerland if such property is used for permanent business purposes. Examples for such commercial properties include manufacturing premises, warehouse facilities, offices, shopping centres, retail premises, hotels, restaurants, workshops or medical practices. Therefore, it is irrelevant whether real estate is used by the acquirer or rented out to a third party in order to pursue a business activity. Commercial properties may also be purchased for investment purposes only.

Main residence properties

Foreigners domiciled in Switzerland not holding a C settlement permit (but a valid B residence permit) are entitled to purchase a dwelling, ie, a single-family house or apartment main residence) at their place of residence without prior approval. The main residence must be acquired directly. Further, the purchase of reasonable land reserves (approximately one-third and in special cases up to one half of the total surface area) for expansion in the medium term of an existing or planned business establishment does not require prior authorisation under Lex Koller.

Acquisition of real estate requiring prior authorisation

In principle, prior authorisation is required for the acquisition of undeveloped land in residential, industrial and commercial zones, though this does not apply if construction works (for main residence or permanent business establishment) commence within approximately one year. However, the construction and lease of residential housing is not regarded as a business activity with the result that the acquisition of such real estate would be subject to the Lex Koller.

A foreigner may acquire a holiday home or a serviced flat in an apartment hotel under certain circumstances and only directly with his own name. The dwelling must be in a place designated by the cantonal authorities as a holiday resort. Every authorisation must be deducted from the annual quota assigned to the cantons for holiday homes and serviced flats.

Further remarks regarding Lex Koller

In terms of fiduciary transactions, it should be noted that persons who are, in principle, not subject to Lex Koller (eg, Swiss citizens) are nevertheless considered foreigners for Lex Koller purposes if they acquire a property that falls under Lex Koller on behalf of a foreigner in a fiduciary transaction. Fiduciary transactions are generally viewed as a circumvention of Lex Koller.

Finally, we would like to draw your attention to the fact that the right to acquire real estate in Switzerland under Lex Koller does not confer in any way a residence entitlement to the relevant owner. Residence permits are granted solely on the basis of the applicable immigration laws.

Pending revision of Lex Koller

In April 2015, the Federal Council announced that it will 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. The presentation of the draft of the revised Lex Koller is expected for the second half of 2016.

Secondary residence: new legislation

On 11 March 2012, the Swiss population voted to accept an initiative which prohibits to the Swiss communes to have a contingent of more than 20% of secondary residence on their area, compared to buildings used as primary residences. This limitation acts as a complete ban for additional authorisations. Every object whose occupant does not have domicile in the municipality falls under the new regulation. Owners of secondary residences will still be able to sell their properties as secondary residence in the future but there is no possibility to build new secondary residences if the contingent is exceeded.

On 1 January 2016 the Federal Act on Second Homes and the Federal Ordinance on Second 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 accommodation or in case the maintenance of a building within the building zone cannot otherwise be guaranteed.

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 subjected 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. However, it needs to be mentioned that there is still no Swiss SICAF in place.

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 managers of collective investment schemes is the '*Eidgenössische Finanzmarktaufsicht*' (FINMA). With regard to anti-money laundering regulations, various rules apply to investment advisers or non-regulated asset managers, set by each of the different financial industry associations that these advisers are obliged to join (SRO, self-regulatory organisation).

CISA was under partial revision. The amendments particularly pertain to the areas of management, custody and distribution of collective investments. The partial revision which entered into force as of 1 March 2013 being in line with international standards (especially AIFMD) increases the protection of investors and strengthens the competitiveness of Switzerland as a fund location.

Besides the modifications which will apply to every fund, the specific changes which will affect only real estate funds are relatively sparse. Also worth mentioning is that it is not intended for real estate funds to be obliged to implement the Key Investor Information Document (KIID). However, a simplified prospectus has to be issued.

General tax aspects

Rental income

Net rental income is taxable in Switzerland at the appropriate 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 federal tax authorities, which are usually also used by the cantonal tax authorities, indicate the following rates on a reducing balance basis, ie, on the book value.

For commercial buildings, office and bank buildings as well as department stores:

- 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. This approach is used, for example, 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 WHTs. 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 WHTs 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.

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 (eg, canton of Zurich).

Loss carryforward

There are no provisions for the carryback of losses. 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.

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 is regarded as hidden profit distribution and is 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.

The standard VAT rate in Switzerland is 8% 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 Anlagefonds*') 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 9.18%). 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 18.36%) 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 securities transfer tax.

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.

Contacts

Advisory

Kurt Ritz
Tel: +41 58 792-1449
E-mail: kurt.ritz@ch.pwc.com

Marie Seiler
Tel: +41 58 792-5669
E-mail: marie.seiler@ch.pwc.com

Assurance

Guido Andermatt
Tel: +41 58 792-2540
E-mail: guido.andermatt@ch.pwc.com

Markus Schmid
Tel: +41 58 792-6358
E-mail: markus.schmid@ch.pwc.com

Tax

Victor Meyer
Tel: +41 58 792-4340
E-mail: victor.meyer@ch.pwc.com

Martin Meyer
Tel: +41 58 792-4296
E-mail: martin.meyer@ch.pwc.com

Dr Nikolaus Honauer *(VAT)*
Tel: +41 58 792-5942
E-mail: nikolaus.honauer@ch.pwc.com

Dr Sandra Ragaz
Tel: +41 58 792-4469
E-Mail: sandra.ragaz@ch.pwc.com

Legal

Lukas Bühlmann
Tel: +41 58 792-7283
E-mail: lukas.buehlmann@ch.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Taiwan

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Taiwan 3

Real Estate Investments – Taiwan 4

Contacts 11

All information used in this content, unless otherwise stated, is up to date as of 20 April 2016.

Real Estate Tax Summary – Taiwan

Foreign entities (including individual and company) 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 a reciprocal approval for Taiwanese nationals and Taiwanese companies to invest in that country.

Generally, foreign investors are allowed to acquire or lease real estate property in Taiwan such as places of residence, office buildings, shops and factories. If the real estate is acquired for infrastructure, 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 regime in Taiwan has taken effect starting from 1 January 2016. As a result of the implementation of the new real property transfer tax regime, the Selective Goods and Services Sales 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 Taiwanese real estate using either a Taiwanese corporation (ie, a resident company in Taiwan as discussed below) or a Taiwanese branch of a foreign corporation.

Income tax

The income tax regime in Taiwan is divided into the consolidated personal income tax for individuals, or the individual tax, and the profit-seeking enterprise income tax for business enterprises, or the corporate income tax. The term business enterprise refers to any entity that engages in business activities, or has a profit-seeking motive as one of its purposes. Under the imputation, or unitary, tax system, individual resident shareholders are able to claim tax credits from the respective business enterprise tax paid against their individual tax liabilities.

Individuals, irrespective of whether they are residents of Taiwan, are subject to income tax on Taiwan-source income, only under the Income Tax Act (ITA). The residence status determines how an individual will be taxed on Taiwanese source income and whether the Alternative Minimum Tax (AMT) will be applied. A resident individual is subject to marginal rates (ranging from 5% to 45%), with entitlement to personal exemptions and deductions. Non-residents are generally subject to withholding tax on gross income without any personal exemptions or deductions allowed.

A resident company in Taiwan is subject to income tax on its worldwide income. The prevailing corporate income tax rate is 17% effective from 2010. A company is deemed to be a resident for income tax purposes if it is incorporated or established under Taiwanese company law, 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) (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 their Taiwan-source income (but not on their worldwide income), and are also subject to AMT. Non-resident foreign companies are subject to withholding tax on the gross amount of their Taiwan-source income.

Alternative Minimum Tax (AMT)

The AMT, which is effective on 1 January 2006, 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) together with their same year regular income. 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.

AMT
(Alternative Minimum Taxable Income – AMT Exemption) x AMT Rate.

	AMT rate %	AMT exemption limit TWD
Business enterprises	12	500,000
Individual	20	6,000,000

The aim of the AMT is to preserve a tax revenue basis. As such, revenues exempted from income tax assessments such as capital gains from securities transaction etc as regulated under ITA or other laws would need to be added back when calculating AMT. Notably, offshore income of Taiwanese individuals will be included in AMT calculations beginning 1 January 2010.

Transfer pricing

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 may sufficiently provide proof that the pricing of the transactions are at arm's length.

Rental income

Rental income is assessable and taxed at a fixed rate of 17% for companies (ie, rental income shall be a component of regular corporate income tax). In addition, the rental income shall also be subject to a 5% value-added tax.

Respective individual marginal income tax rates (ranging from 5% to 45%) are assessed on rental income received by resident individuals. The rental income of resident foreign individuals and local resident individuals are taxed on a deemed profit basis if the cost of such rental is difficult to establish.

Capital gains on sale of property

The Income Tax Act ("ITA") was amended in June 2015 to tax on a consolidated basis actual gains from property transactions based on combinations of buildings and land (new "Real Property Tax" regime). The new Real Property Tax 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. The taxable base is the market value of the properties reduced by related costs, expenses, and the increase in government-assessed land value for land value incremental tax ("LVIT") purposes. A rate of 17% will apply on Taiwanese corporate

taxpayers; whereas, a tax rate of 35% or 45% will apply on profit-seeking enterprises with foreign head offices located outside of Taiwan (ie, Taiwan branch), depending on whether the property is held for more than or less than one year.

LVIT will remain unchanged by the implementation of the new Real Property Tax regime on property transactions. The total amount of land value increment is deducted from real estate transaction income to avoid double taxation.

A summary of the new Real Property Tax regime for profit-seeking enterprises is as follows:

Item	Description
Taxation Scope	• Sales of any of the following after 1 January 2016 will be subject to the new Real Property Tax regime, except where various criteria are met (see section below on “Exclusions”): - Building - Building and land where the building is situated thereon - Land eligible for being granted a construction permit. • Exclusions: If the building or land is sold after 1 January 2016, and meets any of the following criteria, the sale will be subject to the old taxation regime instead: - Building or land was acquired prior to 2 January 2014 - Building or land was acquired on or after 2 January 2014, but before 1 January 2016, and has been held for over 2 years
Tax Base	Proceed from sale of building and land minus: • Costs • Expenses • Total amount of land value increment calculated based on the Land Tax Act, ie, tax base of LVIT
Tax Rate	• Taiwanese profit-seeking enterprises: 17% (same as current taxation regime) • Profit-seeking enterprises with foreign head-offices located outside of Taiwan, ie, Taiwan branch: - Building/land held for less than 1 year: 45% - Building/land held for over 1 year: 35%

Item	Description
Taxation Method	• Taiwanese profit-seeking enterprises: Combined with annual corporate income tax return filings (same as old taxation regime) • Foreign head-offices of Taiwan branches: Tax of the foreign head-office should be calculated separately by the Taiwan branch according to the prescribed tax rate, and reported within the Taiwan branch's annual corporate income tax return

For any profit-seeking enterprise having its head office outside the territory of the Republic of China who directly or indirectly owned more than a half of an offshore company shares that at least half of the value of such company constituted by building and land within the territory of the Republic of China, its income derived from transaction of such offshore company shares shall calculate and pay the income tax in accordance with the preceding paragraphs.

The old property tax regime still applies to properties purchased prior to 2 January 2014, or those purchased after 2 January 2014 if held for more than two years, where only gain from sale of buildings is subject to corporate income tax assessment, and LVIT applies to increment in government-assessed value of land instead.

Interest expense

Interest expenses are allowed as deductions from rental income for corporate income tax purposes if the interest expenses are related to the principal and ancillary operations. The deduction of interest expenses on related party loans is subject to Taiwanese transfer pricing regulations (see section above on '*Transfer pricing*').

In January 2011, Taiwan introduced the thin capitalisation rule in Article 43-2 of the Income Tax Act. From 2011 onwards, deductible interest expense on intercompany loans is capped at a prescribed intercompany debt-to-equity ratio at 3:1. The new rule generally applies to profit-seeking enterprises, except banks, credit cooperatives, financial holding companies, bills finance companies, insurance companies and securities companies.

Certain costs must be capitalised and are depreciable. An example of such costs includes interest incurred on loans used to finance the construction of a building. Interest incurred for purchase of land before title transfer is effected shall be capitalised.

Further, upon implementation of the Rules Governing Allocation of Costs, Expenses and Losses Related to Tax Exempt Income, interest expenses relating to tax-exempt income may no longer be deductible from taxable income. For example, since gains on the sale of land are not included in corporate income tax under old property tax regime, interest expenses in relation to the purchase of land are subject to restrictions for tax deduction purposes (based on complicated formulas).

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 to non-residents and profit-seeking enterprises having no PEs in Taiwan. No withholding tax is imposed on interest paid to local banks.

Depreciation

Depreciation of fixed assets is calculated, based on the 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 methods.

Loss carryforward

Starting from 2009, 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 its 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 and ranges from 0.2% to 1%.

House tax

Buildings are subject to house tax and the tax is imposed on the taxable present value of buildings 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 value of land upon the transfer of legal title of land and 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

In July 2003, 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). In** 2009, the RPSL was amended to introduce concepts of real estate development trust.

Effective since 1 January 2010, income distributed to the beneficiary certificate holder of the 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 generally subject to a 20% Taiwanese withholding tax. This withholding tax may be reduced if the foreign shareholder is a tax resident of a country with an implemented tax treaty with Taiwan. Foreign investors that invest in Taiwanese real estate using the Taiwanese branch of a foreign corporation are not subject to Taiwanese withholding taxes on repatriation of after-tax profits to the foreign head office (ie, there is no branch profits tax in Taiwan). With respect to taxes on capital gains from sale of property, please refer to the section "*Capital gains on sale of property*" above.

Contacts

Advisory
Kenneth Liu
Tel: +886 2 27295831
E-mail: kenneth.liu@tw.pwc.com

Assurance
Mavis Chang
Tel: +886 2 27296998
E-mail: mavis.chang@tw.pwc.com

Tax
Tony Lin
Tel: +886 2 27295980
E-mail: tony.lin@tw.pwc.com

Rosamund Fan
Tel: +886 2 27296077
E-mail: rosamund.fan@tw.pwc.com

Jack Lee
Tel: +886 2 27296666 Ext. 23682
E-mail: jack.s.lee@tw.pwc.com

Legal
Ross Yang
Tel: +886 2 27296666 Ext. 23892
E-mail: ross.yang@tw.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Thailand

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Thailand 3

Contacts 7

All information used in this content, unless otherwise stated, is up to date as of 8 April 2016.

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 or property fund. 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. The statutory corporate income tax rate was permanently reduced from the previous 30% and is effective for companies with accounting periods commencing on or after 1 January 2016.

Small or medium-sized enterprises, defined as companies or partnerships with paid-up capital on the last day of the accounting period not exceeding THB 5m 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:

Accounting period beginning on or after 1 January 2015 but not later than 31 December 2016:

Net profits THB	Tax rate %
0 to 300,000	0
300,001 or more	10

For accounting periods beginning on or after 1 January 2017:

Net profits THB	Tax rate %
0 to 300,000	0
300,001 to 3,000,000	15
3,000,001 or more	20

Exemption or reduction in corporate income tax rate is also available for certain real estate activities under privileges granted by the BOI.

Rental income and other income derived from real estate in Thailand are taxable. Expenses incurred wholly and exclusively for the purpose of the business are deductible, except those specifically listed in the corporate income tax law, eg, excessive entertainment expenses and artificial or fictitious expenses.

There is no required debt/equity ratio for tax purposes. Interest on a loan used to finance the acquisition of a real estate property is deductible from the date the acquired asset is ready for use in business.

Interest incurred on the acquisition or construction of real property before the property is ready for use must be capitalised as part of the cost of the asset, and may be depreciated once the asset is ready for use in business. The interest is then depreciated over the life of the asset and subject to the depreciation rates prescribed below.

Interest incurred on construction of property for sale is treated as part of the cost of construction until the property is ready for sale.

A market rate of interest must be charged on intercompany lending between Thailand resident companies.

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.

Withholding tax on dividends

Dividends distributed by a local company to its foreign shareholders are subject to a dividend withholding tax at 10%. A DTA with Taiwan came into effect on 1 Jan 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 DTA have '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 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 of 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 specific business tax (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

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.

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.

Contacts

Advisory

Charles Ostick
Tel: +66 2 344 1167
E-mail: charles.ostick@th.pwc.com

Assurance

Sakuna Yamsakul
Tel: +66 2 344 1183
E-mail: sakuna.yamsakul@th.pwc.com

Tax

Paul B.A. Stitt
Tel: +66 2 344 1119
E-mail: paul.stitt@th.pwc.com

Ornjira Tangwongyodying
Tel: +66 2 344 1118
E-mail: ornjira.tangwongyodying@th.pwc.com

Legal

Vunnipa Ruamrangsri
Tel: +66 2 344 1284
E-mail: vunnipa.ruamrangsri@th.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global
The Netherlands

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents ... 2

Real Estate Tax Summary – The Netherlands ... 3

Real Estate Investments – The Netherlands ... 7

Contacts ... 27

All information used in this content, unless otherwise stated, is up to date as of 01 May 2016.

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.

Rental income

Income from Dutch real estate is taxable in the Netherlands at the rate of 25% (2016). Profits up to €200,000 are taxed against a reduced corporate tax rate of 20% (2016).

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.

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 on interest. Further there is no tax on the repatriation of Dutch source real estate income of a non-resident tax payer.

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, the 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), will be limited if the tax book value falls below 50% of the WOZ value.

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/withholding tax 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' in case 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 withholding tax at the rate of 15%. There is no dividend withholding tax on dividends distributed within a fiscal unity for corporate income tax purposes. In addition, no dividend withholding tax is due on dividends paid to a Dutch or EU resident shareholder which has a participation qualifying for the participation exemption in the company paying the dividend. The Dutch dividend withholding tax rate may also be reduced under the double tax treaties concluded by the Netherlands.

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.

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 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 VAT-able supply/lease of property. Such an option can, 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 VAT-able supply/lease, the applicable VAT rate is 21% (2016). An option for VAT-able 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 VAT-able 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.

Real Estate Investments – The Netherlands

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. The present guide has been prepared by the Dutch Real Estate Group to provide general background information on the taxation aspects of property investments in the Netherlands. The guide starts with an overview of the direct and indirect tax aspects of direct property investments. Then, we outline the aspects of the purchase and sale of real estate companies and the investment in Dutch property through a partnership. Further, we will give an overview of the tax aspects of property financing. Finally, we give general information with regard to the Real Estate Group in the Netherlands. Obviously, this guide is not intended to be a comprehensive study on the subject. Accordingly, the advice of qualified professionals should be sought before any decision is reached on a specific point.

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% (2016). On profits up to €200,000 a reduced corporate tax rate of 20% applies (2016).

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 (ie, the acquisition cost plus-related expenses such as registration duties, **brokerage fees, notary's fees, architect's fees, transfer tax**, non-recoverable VAT, etc) is the basis for depreciation and the depreciation rate should be based on the expected useful life of the assets. As a general rule, depreciation rates up to 3.3% 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 (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), will be limited if the tax book value falls below 50% of the WOZ value.

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. However, losses incurred by a 'pure holding' or 'group finance' company can only be offset against profits in other years, provided that the company qualifies as a 'pure holding' or 'group finance' company in such other year and the balance of the loans to and from related parties is not higher than in the year the loss was realised.

Upon a 30% or more change of the of the ultimate ownership of a company, it will no longer be possible to offset tax losses incurred before the change of control with profits realised after the change of control.

A change in the ultimate control in the company is disregarded for purposes of the 30% change-of-control criterion, if the change results from the transfer of shares pursuant to inheritance or matrimonial law, or is the result of an increase in control by an ultimate shareholder who already held a one-third interest in the company at the beginning of the oldest year for which the losses are still available.

Further, if a 30% change of control took place but the company was not or could not have been aware of this change, then the provision does not apply, provided that the change can be considered ordinary trade in the shares of the company at the stock exchange. This can be determined by comparing the trade in these shares with the average trade in these shares in previous years. Furthermore, takeovers, mergers and demergers are not considered usual trade.

Losses are also still available for carry forward in the situation that 30% or more of the ultimate control has changed, and both the passive investment and activity tests have been met.

Passive investment test

The passive investment test is met if, during the year the loss was realised and the year the loss was offset against taxable profit, no more than 50% of the assets of the company comprised of portfolio investments for a period of at least nine months in each of these years.

For the purposes of the passive investment test, cash as well as real estate, which is made available to third parties, is deemed to be a portfolio investment.

Activity test

The activity test is met provided that the following is met:

- Immediately prior to the change of ultimate control, the level of activities of the company was not reduced by more than 70% compared to the level of activities at the beginning of the earliest year in which the tax losses are still available for carry forward (scale-down operations).

- At the time of the change in the ultimate control, there was no intention to, within a period of three years, reduce the level of activities performed at that time by more

than 70% of the level of activities performed at the beginning of the earliest loss year for which the losses are still available for carry forward (scale-down operations).

The activity test should be applied at the level of the 'taxpayer'. Consequently, if a company is part of a fiscal unity, the activity test should apply to the entire fiscal unity, ie, the parent company is the representative taxpayer for all 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 forms 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 52% (2016). 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% (2016). 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 of 4% of the value of the net assets. The notional yield is taxed at a flat rate of 30% (2016). The tax (1.2% of the average value of the net assets per year) is levied, irrespective of the actual positive or negative yield realised. This means that either more or less than the actual proceeds can be subject to tax. Based on proposed legislation, as from 1 January 2017 the notional return on Box 3 assets is calculated on the basis of ascending fixed percentages:

- 2.9% on assets up to a total value between €25,000 to €100,000;
- 4.7% on assets up to a total value between €100,000 to €1,000,000;
- 5.5% on assets up to a total value exceeding €1,000,000.

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 2016 an amount of €24,437 will be tax-free. As from 1 January 2017 assets with a total value up to €25,000 will be exempt from Box 3 taxation.

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 52%). 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. This 6 month period was extended to 36 months for (first) acquisitions that took place between 1 January 2013 and 1 January 2015.

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.

Value-added tax (VAT)

General

The basic concepts of the Dutch VAT system, such as taxable persons, nature of goods and supply of goods and services are in line with the sixth EU VAT Directive. The Dutch VAT regulations are, therefore, roughly comparable to those applicable in other EU Member States.

A taxable person is any person who regularly and independently carries out economic activities, ie, the supply of goods or services.

Tax rate

The general VAT rate is 21% (2016).

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 VAT-able supply. Such an option can be included in the deed of transfer. This can also be achieved by filing an option request for a VAT-able 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 VAT-able 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 VAT-able 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 VAT-able 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 VAT-able activities (eg, VAT-able 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 VAT-able and VAT-exempt activities, the recovery of input VAT with respect to this property is determined by calculating the proportion between the VAT-able and total activities: the VAT recovery 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 (for example: 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 VAT-able 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 VAT-able. 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 VAT-able 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

General

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 2016 is 1 January 2015. 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 2016 is determined on the basis of market prices on the reference date 1 January 2015.

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 2016. 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 2016. The average owner tariff for non-residential real estate for the real estate tax is approximately 0.23% of the total value for the tax year 2016. 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 2016 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.

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.

Tax aspects

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.

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'. Generall**y 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 particip**ation 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 new 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. 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 withholding tax at the rate of 15%. There is no dividend withholding tax on dividends distributed within a fiscal unity for corporate income tax purposes. In addition no dividend withholding tax is due on dividends paid to a Dutch or EU resident shareholder which has a participation qualifying for the participation exemption in the company paying the dividend. The Dutch dividend withholding tax rate may also be reduced under the double tax treaties concluded by the Netherlands.

Gains from the sale of shares in a Dutch real estate company by a non-resident corporate investor is – apart from specific abusive situations – not subject to corporate income tax in the Netherlands. The same applies to dividends received by a non-resident company from a Dutch company. However, such dividends and capital gains are subject to 15%-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 dividend tax or personal income tax and if it is not put into place with valid commercial reasons which reflect economic reality.

Personal income tax

General

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 (2016). These benefits include the following:

- Dividends or profit rights.
- Capital gains realised on the transfer of shares or profit rights.
- 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. This means the income will be based on a fictitious return of 4% of the value of shares and taxed at a fixed rate of 30% (2016). Consequently, 1.2% tax will be effectively levied on the total of shares in Box 3. For the proposed changes of the Box 3 taxation **as per 1 January 2017 we refer to chapter 'Personal income tax –** resident **individuals' before.**

Dividend distributions by a Dutch company to its Dutch resident individual shareholders are subject to a 15% dividend withholding tax.

The dividend withholding tax 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 withholding tax on dividends distributed by a Dutch BV/NV company to these shareholders. The withholding tax rate may be reduced under a tax treaty.

The Netherlands do not levy any withholding taxes 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 on interest of one-third or more is subject to 6% real estate transfer tax (2% on residential property) on the proportionate part of the fair market value of the property (directly or indirectly) represented by the interest acquired.

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. This six months period was extended to 36 months in case the initial acquisition took place between 1 January 2013 and 1 January 2015.

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

General

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.

Tax aspects

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

General

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 withholding tax.

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 withholding tax. 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

Tax aspects

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 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.

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.

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.

VAT

The financing of property with a (mortgage) loan is VAT-exempt.

Withholding tax

The Netherlands do not levy withholding taxes on interest payments, with the exception of certain hybrid debts.

Contacts

Advisory / Deals

Wilbert van den Heuvel
Tel: +31 88792-3816
E-Mail: wilbert.van.den.heuvel@nl.pwc.com

Erik Troost
Tel: +31 88792-7085
E-Mail: erik.troost@nl.pwc.com

Assurance

Eric Hartkamp
Tel: +31 88792-5158
E-mail: eric.hartkamp@nl.pwc.com

Bert Oosterloo
Tel: +31 88792-5245
E-mail: bert.oosterloo@nl.pwc.com

Sidney Herwig
Tel: +31 88792-4936
E-mail: sidney.herwig@nl.pwc.com

Tax

Jeroen Elink Schuurman
Tel: +31 88792-6428
E-mail: jeroen.elink.schuurman@nl.pwc.com

Bart Kruijssen
Tel: +31 88792-6037
E-mail: bart.kruijssen@nl.pwc.com

Martin van der Zwan
Tel: +31 88792-6467
E-mail: martin.van.der.zwan@nl.pwc.com

Serge de Lange
Tel: +31 88792-6390
E-mail: serge.de.lange@nl.pwc.com

Jelle Bas Boon
Tel: +31 88792-7642
E-mail: jelle.bas.boon@nl.pwc.com

Wanda Otto
Tel: +31 88792-7374
E-mail: wanda.otto@nl.pwc.com

Brian Adams
Tel: +31 88792-6363
E-mail: brian.adams@nl.pwc.com

Valuations

Jens Osinga
Tel: +31 88792-7590
E-Mail: jens.osinga@nl.pwc.com

Rob Jansen
Tel: +31 88792-7548
E-Mail: rob.jansen@nl.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global Turkey

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – Turkey 3

Contacts 13

All information used in this content, unless otherwise stated, is up to date as of 24 May 2016.

Real Estate Tax Summary – Turkey

General

According to article 35 of Land Registry Law numbered 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 Council of Ministers is the competent authority to determine the nations of whose citizens may acquire real estate in Turkey; 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 estates in Turkey, only if such acquisition is allowed under the specific laws, ie, Petroleum Law, Tourism Encouragement Law.

On the other hand, establishing a company that will be resident in Turkey in order to acquire real estate or limited real right is also subject to some restrictions according to article 36 of the Land Registry Law. Companies established in Turkey by foreign investors are deemed to be Turkish companies, but their acquisition of real estate and limited real rights in Turkey have been restricted by the decision of Constitutional Court on 11 March 2008 to cancel article 3(d) of the Foreign Direct Investment Law, which offered equal terms and conditions in acquiring real estate to both (i) a national

company with a domestic capital and (ii) companies established in Turkey by foreign investors.

According to article 36 of the Law, companies established in Turkey by foreign investors may acquire and use real estate ownership or limited real rights, in order to achieve objectives set out in their articles of association. The same principle applies to a transfer of the real estate to another foreign capitalised company established in Turkey, or in a case where a national company with domestic capital owning a real estate becomes a foreign capitalised company by means of a share transfer transaction.

Real estate acquisitions by these types of companies in military forbidden zones, security zones as well as in strategic zones are subject to the permission of the Turkish General Staff or commandership to be authorised by the General Staff, whereas such acquisitions in private security zones are subject to the permission of the relevant local governorship. Permission depends on how well the acquisition is seen to conform to the country's safety and the company's scope of activity. The decision is therefore taken by a commission appointed within the governorship representing the relevant administrations.

Article 36 also provides that any acquisition made in contravention of the Law will be liquidated by the Ministry of Finance, unless the owner liquidities 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 return, and is subject to 20% corporate tax.

Dividend withholding tax

Dividends when distributed to non-residents or individual shareholders are subject to withholding tax 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 corporation tax rate 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 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, 75% of the capital gains derived from disposal of property are exempted from corporate tax provided that the property is held for at least two years. In order to benefit from this 75% 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 that 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.

Please note that distribution of that income in any way or liquidation of the company within five years will lead to full taxation.

Please note that 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 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 since 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 is at least 10%.

Net capital gains calculated as such are subject to corporate tax and dividend withholding tax as discussed above. Note that the 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. The cost adjustment can only be made, however, 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 11,000 TRY (approximately €3,400 under 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 his 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
- 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 150 sqm will be subject to 1% VAT. However, 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:

I. building license obtaining date
II. construction class of the building
III. m² of the house
IV. whether it is built on a Metropolitan Municipality area or not
V. whether it is built on an area which is qualified as reserve construction or risky or on a location where risky building exist based on Law No. 6306 on the Transformation of Areas Under Disaster Risk
VI. the land unit m² tax value

VAT, if incurred by non-resident companies, cannot be offset or recovered, and should be considered as part of the cost.

Title deed fee

The acquisition of legal title to Turkish property is subject to 2% title deed charge on the higher of property tax value or the transaction amount. The same charge will apply when the property is sold. This charge is applied separately for buyer and seller. As a result, the total title deed charge over the property that has to be paid would be 4%.

Stamp tax

Stamp tax is calculated over the sales price of the real estate property indicated in the asset purchase agreement (if any) at a rate of 0.948% with a ceiling of 1,797,117.30 TRY (approximately €558,597 under current foreign exchange rate; subject to annual revaluation) for the year 2016. Note that each and every signed copy of an agreement is separately 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, however, 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 within the borders of metropolitan areas.

Envisaged legislative amendments

Please note that the Government has submitted the Draft Income Tax Law to the Turkish Parliament. The current Income Tax Law and Corporate Tax Law are being merged into one single code in the Draft Income Tax Law and have been submitted to

the Turkish Parliament by the Council of Ministers. The draft law in particular brings some important changes regarding the taxation of capital gains of individuals and corporations from immovable and equities.

Under the Draft Income Tax Law, the current exemption with respect to the real estate disposal after two years holding period for corporations at a rate of 75% will be amended and the exemption rate shall gradually increase depending on the holding period of assets (two to five years). Additionally, the current 100% exemption for individuals, who have held immovables for five years, will be amended. The Draft Law does not allow the 100% exemption and exemption rates gradually increase as the holding period increases instead of the current one single threshold.

Please also note that, in addition to the above stated amendments regarding the exemptions, Draft Income Tax Law is also expected to bring about certain important amendments which will impact the taxation of real estate investments. Since the draft law is currently under discussion in Parliament, the potential amendments should be monitored carefully and should be considered during the planning of existing and potential investments in Turkey.

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 31 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 3 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 2016.

Taxation of a REIC

Profits generated from the activities of REIC are exempt from corporate 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) since the withholding tax rate is determined as 0% for REICs by the Council of Ministers, dividend distributions to individual and non-resident shareholders of the REICs currently have no dividend withholding tax burden at all.

Dividends received by resident corporations

Since REICs are exempt from corporate tax 'participation exemption' is not applicable for the dividends received from REICs. So, dividends received by corporations in Turkey from REICs are subject to corporate income tax at the rate of 20%. And then, if distributed to non-resident companies or individuals, those distributions are also subject to dividend withholding tax in line with local regulations.

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 (approximately €9,000 for the year 2016). 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

The capital gains derived from the sale of REIC shares by resident legal entities is to be included in the corporate income and will be subject to corporate income tax at 20%. However, there is a special partial exemption method that can be used to minimize tax burden which is available for 75% of the gains derived from the sale of shares that are held for at least two years, with 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 withholding tax. The current rate of 0% withholding tax is applicable for the 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 with the wholesale price index

except for the month in which the shares are sold if the total increase in WPI is more than 10%), within 15 days following the sale of shares, through a special corporate tax return and be taxed at standard corporation tax rate. Additionally, a dividend withholding tax 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, it is strongly advised that examination of double tax treaties be made 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 withholding tax. The current rate of 0% withholding tax 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 withholding tax. The current rate of 0% withholding tax 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 becomes effective on 1 July 2014. Thus, effective from July 2014 it will be legally 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.

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 specialized fund which is accessible to only QIs.

QI Status; any person owning at least 1m TRY 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 organizations, 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 TRY 10 million 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 corporate tax. Moreover, REIF income benefitting from corporate tax exemption is also subject to 0% withholding tax. There is no further withholding taxation upon dividend distributions/ redemptions to/by QIs of REIFs.

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”.**

The transactions of REIFs are also subject to VAT and most other transfer taxes.

Taxation of investors receiving dividends from a REIF

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) since the withholding tax rate is determined as 0% for REIFs by the Council of Ministers, dividend distributions to individual and non-resident shareholders of the REIFs currently have no dividend withholding tax burden at all.

Dividends received by resident corporations

For resident corporate QIs (including non-resident corporate taxpayers that have a permanent establishment such as a branch office in Turkey), dividends from REIFs are subject to corporate tax at the rate of 20%. In other words, corporate QIs cannot benefit from the participation exemption with respect to their investment incomes from Turkish REIFs.

And then, if distributed to non-resident companies or individuals, those distributions are also subject to dividend withholding tax in line with local regulations.

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

Individual QIs resident in Turkey and participating in REIF(s) benefit from an income tax exemption in respect of half of the gross dividend amounts received from REIFs. Where the remaining amount exceeds a statutory threshold (approximately €9000 for 2016), statement of such amount should be declared in annual income tax returns. Declared income will be subject to income tax at the progressive rate between 15% and 35%.

Dividends received by non-resident individuals

Non-resident individual QIs participating in REIF(s) are not required to make any tax filing. Thus, 0% withholding 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.

Contacts

Advisory
Hüsnü Can Dinçsoy
Tel: +90 212 3265302
E-mail: husnu.dincsoy@tr.pwc.com

Assurance
Engin Çubukçu
Tel: +90 212 3266061
E-mail: engin.cubukcu@tr.pwc.com

Tax
Ersun Bayraktaroğlu
Tel: +90 212 3266098
E-mail: ersun.bayraktaroglu@tr.pwc.com

Baran Akan
Tel: +90 212 326 6678
E-mail: baran.akan@tr.pwc.com

Legal
Nilgün Serdar Şimsek
Tel: +90 212 326 6461
E-mail: nilgun.serdar@tr.pwc.com

www.pwc.com/goingglobal

Real Estate Going Global United Kingdom

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Investments – United Kingdom 3

Contacts 42

All information used in this content, unless otherwise stated, is up to date as of 03 May 2016.

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 teams of PwC LLP and PwC Legal 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.

The Scotland Act enacted on 1 May 2012, includes powers for the Scottish Parliament to set a rate of income tax in Scotland higher or lower than the UK rate and to replace UK **Stamp Duty Land Tax ("SDLT") with a transaction tax** applying to Scottish land.

Land and Buildings Tax ("LBTT") replaced UK SDLT in Scotland from 1 April 2015.

The Scottish rates of income tax are expected to be introduced in 2016.

Introduction

There have been a number of changes affecting the taxation of real estate in recent years.

A number of changes have also been included in Finance Bill (No. 2) 2016.

In particular, the top rate of Stamp Duty Land Tax ("SDLT") applying to acquisitions of UK commercial property has increased from 4% to 5% with effect from 1 April 2016. A 3% supplement to the residential SDLT rates has also been 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 also announced changes relating to trading in UK land, and restrictions on interest deductibility and loss relief. Legislation in respect of these changes has not yet been published although the changes are expected to take effect from April 2017.

Where relevant, reference to the proposed changes has been made below.

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 2016/2017 an individual is subject to basic rate income tax at 20% on net taxable income up to £43,000, and then to higher rate income tax at 40% on net income falling between the limits of £43,000 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 income 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.
- 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, or notify HMRC of its investment in UK real estate. 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. In leases of investment properties, landlords must try to recover as much of their expenditure as possible to ensure that the leases they are granting are acceptable in the investment market (see section '*Institutional leases*' below).

Interest payments

Interest is in principle deductible on an accrual basis where the interest is paid wholly and exclusively for the purposes of the UK rental business.

However, 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.

The proposed interest cap to be introduced by the UK government from 1 April 2017 in response to the OECD's **Base Erosion and Profit Shifting ("BEPS")** project (see further **"Interest Payments" section below for further details) is currently** expected to apply to corporation tax only and not to income tax payers. However, the possibility of these rules being extended in the future to income tax payers should not be discounted. In addition, investors paying income tax at the higher and additional rates on their rental income from residential property will see a restriction on interest relief phased in from April 2017.

Over the 4 years from April 2017, tax relief for financing costs incurred by residential landlords is to be phased out. The current relief for finance costs will be phased out as follows:

- For 2017-18, the deductible amount in respect of the finance costs will be 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 £200,000of expenditure on plant and machinery (other than cars). One such allowance is available to each individual business or corporate group.

- A 100% business premises renovation allowance for expenditure on the conversion or renovation of certain business properties which have been vacant for at least one year and lie within a designated disadvantaged area.

- 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 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 will only be subject to UK corporation tax if it carries 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.

If a non-resident company carries on trading activities elsewhere in the UK, then it may be 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.

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 are normally carried forward 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, measures have been announced in the March 2016 Budget which restrict to 50% the amount of profit which a company can offset through losses carried forward. Legislation has not yet been published, but the changes are intended to take effect from 1 April 2017.

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 2016 to 31 March 2017, is 20%.

A further 1% reduction is proposed from 1 April 2017, resulting in a main rate of corporation tax rate of 19%, with a further reduction to 17% in the financial year commencing 1 April 2020.

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 will be charged on underpaid quarterly tax, and penalties can apply in some cases. This system is being introduced in stages over three years.

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. 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.

Since 2010, the UK's debt cap rules have also operated to restrict corporation tax deductions for interest and other finance expenses claimed by members of a large group, by reference to the group's consolidated finance costs (although these rules are to be repealed and replaced as part of the UK's implementation of the BEPs proposals on interest – see below).

In addition, the OECD view is that member states' current interest limitation rules do not adequately address Base Erosion and Profit Shifting ("BEPS"). The OECD is therefore recommending that members introduce a rule which limits net deductions for interest to between 10% and 30% of a company's EBITDA, which can be potentially supplemented by a group ratio test.

The UK government has confirmed that an interest cap for companies will be introduced from 1 April 2017 under which net interest tax deductions are to be restricted to 30% of the UK company's EBITDA.

A group ratio test will also be introduced to supplement the single company test, and there will be a *de minimis* interest limit of £2m for the UK group.

Legislation is expected late 2016.

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).
- 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 now 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.
- 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 has been introduced in Finance Bill (No. 2) 2016 to provide relief from **SDLT on the initial "seeding" of real estate to the PAIF.**

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.

Landlords may therefore 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 individuals, and if any of those individuals are UK-resident, then their share of the gain will be taxable in the UK.

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'***). Where a non-resident company carries on a trade through a PE in the UK, chargeable gains realised on the assets of its PE are also subject to corporation tax.

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, eg, where a loss arises on a connected party disposal or where there is no real commercial disposal, and where there has been a change in the ownership of the company.

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 are only usually subject to UK tax if the owner carries on a trade through a PE in the UK, subject to corporation tax, or exercises a trade in the UK subject to income tax.

If the non-resident owner does not trade in the UK, it is nevertheless possible for the UK tax authorities to use UK anti-avoidance provisions to tax the profit on disposal in certain circumstances. To date, it has been the case that tax treaties with certain countries have often prevented the UK tax authorities from being able to apply the anti-avoidance legislation, but this has depended upon the exact circumstances of the case.

Going forward however, the UK government announced in the March 2016 Budget further anti-avoidance measures in relation to profits from trading in and developing UK land. Legislation has not yet been published, but it is intended that from 1 April 2017, non-resident companies should be subject to UK tax on the profit arising in the following situations:

- Where the non-resident company holds property on trading account;
- Where the non-resident company provides property development services in relation to UK property development; or
- Where there is "disguised" trading in UK property by means of an indirect disposal (eg where the non-UK resident company sells shares in a company which owns UK property).

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.
- 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.

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, enhancement expenditure and indexation allowance, which 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, will normally be exempt from UK tax. However, anti-avoidance provisions can treat the gain as income in certain circumstances where the underlying property has been acquired or developed with a trading motive.

See also the reference above (see section ***'Trading in real estate")*** to the new anti-avoidance rules which will be introduced from 1 April 2017 which will subject to UK tax the profits arising on a sale of shares by a non-UK company where the company being sold acquired property with a view to realising a profit.

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 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.

Development profits

Where it is not clear that real estate is being developed for the purpose of long-term investment, it may be very difficult for a non-UK resident developer to avoid having a taxable presence in the UK.

To date, real estate development profits have been liable to UK tax in three main circumstances.

- When a developer who can claim the benefit of an appropriate double tax treaty has a PE in the UK, which is involved with the development.
- When a developer who is not protected by a double tax treaty is trading in the UK whether or not through a PE.
- When a developer acquires or develops real estate in the UK with the sole or main object of realising a gain from disposing of the land.

The meaning of a PE is similar to that of a branch or an agency, but many treaties specifically include a construction site that lasts for more than 6 or 12 months. An agent or adviser who has and habitually exercises authority to negotiate or conclude contracts in the name of the developer will usually cause the developer to have a PE in the UK. Many double tax treaties also give protection against the circumstance set out in the third circumstance above.

It is therefore clear that it will be very difficult for a non-UK developer to avoid tax on a UK property development. To date this has however been possible where the non-UK developer could claim the benefit of a double tax treaty exemption for a short-term construction site, and also avoided having an agent in the UK.

Avoiding tax on UK property development in this way has arguably been more difficult since the introduction of Diverted Profits Tax in April 2015 which is designed to counteract, amongst other things, arrangements contrived to avoid a UK PE.

As referred to above however (at **section '*Trading in real estate*'**), the UK government announced in the March 2016 Budget further anti-avoidance measures in relation to profits from trading in and developing UK land, which are likely to remove the possibility of a non-UK developer avoiding UK tax on a UK property development.

Legislation has not yet been published, but it is intended that from 1 April 2017, non-resident companies will not be able to avoid UK tax on the profit arising where the non-resident company holds property on trading account or provides property development services in relation to UK property development.

Where necessary to achieve this result, it is intended that amendments to tax treaties be negotiated.

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 £83,000 a year (as at April 2016). A business can register voluntarily if the taxable turnover is below this figure. A property developer or investor can also register for VAT on the basis of clear intentions to make taxable supplies in the future – this facilitates recovery of VAT on initial investment appraisal, acquisition and development costs at an early stage. Investing in UK real estate and charging rent is considered to be carrying on a business in the UK for VAT purposes, although these supplies are not always subject to VAT.

Types of supply

Essentially, there are four different liabilities of supplies for VAT purposes:

- For standard-rated supplies, the supplier charges VAT at 20%, and can recover VAT charged on supplies received that directly relate to the standard-rated supply made by supplier.

- For reduced rate supplies, the supplier charges VAT at 5% and can recover VAT on supplies received that directly relate to the reduced-rated supply. The reduced rate relates to domestic fuel and utilities, and certain works related to renovating and converting buildings for use as dwellings.

- For zero-rated supplies (equivalent to the EU exempt with right of refund), the supplier does not charge VAT on supplies, but still recovers VAT charged on supplies made to it that directly relate to the zero-rated supply made by it.

- For exempt supplies, the supplier does not charge VAT, and cannot recover VAT on supplies directly related to the exempt supply.

Certain supplies, broadly speaking exported services, are outside the scope of VAT, with or without right of recovery of the VAT on related costs. For practical purposes, such supplies can be treated as zero-rated or exempt, respectively. The main exception to this rule within the property sector is any services that relate to land situated in the UK, which remain within the scope of UK VAT, regardless of where the recipient of those services is established. Examples of this would be property valuation and surveys, estate management services and physical work performed on real estate in the UK, which would all be subject to VAT at the standard rate of 20%.

Some transactions may fall outside the above categories, as they do not constitute supplies for VAT purposes, for example transfers of property development or investment businesses as going concerns (specific conditions need to be met for the transfer of real estate to be seen as the transfer of a going concern), dilapidations payments, dividends and planning gain improvements.

Real estate supplies

The sale or grant of an interest in real estate is generally exempt from VAT, with the supplier having the option to charge VAT at the standard rate on supplies of commercial real estate. The major exception to this is the sale of the freehold interest in new (less than three years old) commercial buildings, which is automatically standard-rated, along with some other leases and lettings in relation to transactions such as car parking, and hotel and holiday accommodation. Most building work is standard-rated, but the construction of new dwellings and of certain buildings intended to be used for qualifying charitable or relevant residential purposes is zero-rated. 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	VAT Treatment	VAT Rate %
Construction of residential buildings.	Zero-rated	0
Qualifying conversion and renovation works on residential buildings.	Reduced rated	5
All other works on residential buildings.	Standard-rated	20
The first-time sale, including leases exceeding 21 years (in Scotland, leases of no less than 20 years) of:		
(a) a new residential building by the person who constructed it	Zero-rated	0
(b) a substantially reconstructed listed residential building by the person who substantially reconstructed it	Zero-rated	0

Transaction Type	VAT Treatment	VAT Rate %
(c) a residential building converted from a commercial building or a renovated residential building, which has not been used as a residential building for at least ten years	Zero-rated	Nil
Sale (other than the first sale) of a residential building	Exempt	0
Other leases in residential buildings	Exempt	0
Construction of non-residential buildings	Standard-rated	20
Repair and maintenance of any buildings	Standard-rated	20
Sale of freehold interest in a new non-residential building	Standard-rated	20
Sale of an existing (ie, not new) non-residential building	Exempt/Standard-rated	0/20
Grant of a lease in a non-residential building	Exempt/Standard-rated	0/20

For these purposes, a non-residential building is treated as new until it is three years old, counted normally from practical completion. In addition, there are certain categories of leasing and letting, such as the right to park cars, self-storage accommodation in hotels, etc, which are excluded from exemption and are, as a result always standard-rated.

Option to tax

Once a building has been subject to an option to tax, all rents and sales proceeds generated by that building 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. Prior to 1 April 2016, SDLT was payable on land transactions at the rate of 4% of the VAT-inclusive consideration if it exceeded £500,000, with reduced rates where the consideration is less.

From 1 April 2016, the top rate of SDLT has increased to 5%, and applies 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:

Purchase Price £	Rate %
Up to 125,000	0
Over 125,000 and up to 250,000	2
Over 250,000 and up to 925,000	5
Over 925,000 and up to 1,500,000	10
Over 1,500,000	12

From 1 April 2016, however, an additional 3% will be 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:

Purchase Price £	Rate %
Up to 125,000	3
Over 125,000 and up to 250,000	5
Over 250,000 and up to 925,000	8
Over 925,000 and up to 1,500,000	13
Over 1,500,000	15

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 in Scotland is not subject to SDLT and is instead **taxed under the separate Scottish Land and Buildings Transaction Tax (“LBTT”).**

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, 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 £920 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 2016/17 the standard multipliers are 49.7% for large businesses and 48.4% for small businesses. Large properties are defined as those with a rateable value of £18,000 or above (£25,500 in London). The 2016/17 multiplier in Wales is 48.6%, there is no small business multiplier.

In addition, from April 2010, the Mayor of London introduced a levy of 2% of rateable value on non-domestic properties with a rateable value of over £55,000 in London. This will help pay for Crossrail, the new east-west train link.

Rates at these percentages of rateable values are charged annually to business occupiers, and since 1 April 2008 they have also been applicable to vacant property.

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 2010, and revaluations normally take place every five years. However, the next was postponed and will take effect 1 April 2017. Open market rental values in April 2008 form the basis of rateable values that came into effect from April 2010 and for those coming into effect 1 April 2017 the basis will be rental values as at 1 April 2015. Rateable values are assessed and published in a Rating List by the Valuation Office Agency (part of HMRC).

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 4 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

The temporary relief measure doubles the usual rate of relief so that ratepayers with rateable values below £6,000 pay no rates at all, while ratepayers with rateable values between £6,000 and not more than £12,000 receive tapered relief from 100% to 0%. There is a buffer zone for qualifying small business properties with a rateable value between £12,000 and £18,000 who will not contribute to the scheme. Similar schemes operate in Scotland, Wales and Northern Ireland.

From 1 April 2017, in England, the doubling of relief will be permanent and the thresholds will change so that 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%. The buffer zone will be £15,000 and £51,000.

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 were introduced on a temporary basis.

New buildings, completed between 1 October 2013 and 30 September 2016, which remain empty qualify for an exemption from empty rates for up to 18 months.

Businesses that moved into retail premises between 1 April 2014 and 31 March 2016, which were previously empty for 12 months or more, qualify for a 50% reduction in rates for up to 18 months.

From 1 April 2014 to 31 March 2016, qualifying shops, public houses and restaurants with rateable values below £50,000 are entitled to £1,000 relief for 2014/15 and £1,500 for 2015/16.

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.

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 admini**strative 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
- 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 (ie, 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 adm**inistrator 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:

Alienation	The transfer of an interest in a leasehold property, which includes an assignment, underletting, charging of an interest or parting with occupation or possession.
Apportionment	The division of a benefit or a liability between two or more parties according to their proportionate interest following an event that occurred during a payment period. For example, where a lease is sold, often rent will have been paid by the seller for a period in advance. On the sale, that part of the rent that has been paid in advance, and which relates to the period after the lease has been sold, will be apportioned. The buyer will in effect reimburse the seller, and both parties will have paid the rent attributable to their period of ownership.
Beneficial interest	The interest in property of the person entitled to the benefit or enjoyment of the property. The beneficial interest is separate from the legal interest, which is the interest of the person who can prove legal title to the property. Legal ownership does not necessarily mean that the legal owner is entitled to the benefit of the property. They may hold the legal interest on trust for the person who is the owner of the beneficial interest in which case the financial rewards of ownership may initially be paid to the legal owner, but they are under a duty to pass them to the beneficial owner.
Best rent	The highest rent that can reasonably be expected by a landlord in the circumstances of a particular case.

Term	Definition
Betterment	Any increase in the value of a property as a result of action by the government, either local or national. This could be positive action such as the construction of a new road benefiting the property, or negative as where restrictions are imposed which have the effect of benefiting the property concerned. It can also mean the value added to a property attributable to an improvement.
Break clause	A clause in a lease which gives the landlord and/or tenant a right to terminate the lease before its contractual expiry date.
Building scheme	A development project in which land is laid out in plots and sold to different purchasers or leased to different tenants, all of whom enter into mutually enforceable restrictive covenants with the common seller or landlord.
Capitalisation	The conversion of a series of net receipts over a period into the equivalent capital worth.
Commonhold	Form of land ownership that combines freehold ownership of a single property within a larger development, with membership of a limited company that will own and manage the common parts of the development. Although most likely to be used in relation to residential flats, commonhold is also suitable for houses and commercial developments.
Common land	Land over which the inhabitants of a particular locality enjoy rights in common with the owner of the land, eg, rights of way and grazing rights.
Completion	The final step in the legal process of transferring ownership of property. It is the point at which the legal documentation evidencing the transfer is signed and dated and when the purchase price for the property is paid.
Consideration	The payment given by one party to a contract to the other, eg, the price paid by the buyer of a property to the seller.
Contract	A legally binding agreement. A contract for the disposal of an interest in land is unenforceable unless it is in writing, contains all the terms of the contract and is signed by or on behalf of the parties.
Covenant	An obligation undertaken by one party and effected by a deed. Covenants will usually be express, but can also be implied by statute. Covenants can be entered into in relation to freehold land, as freehold covenants, or in relation to leasehold land, as leasehold covenants. If the covenant requires the person giving it to do something, the covenant is referred to as a positive covenant. If the covenant restricts what the person giving it can do, it is said to be a restrictive covenant. Both the landlord and tenant will enter into covenants that will be set out in the lease. The ability and willingness of the tenant to comply with its leasehold covenants is referred to as the covenant strength, so that a tenant of sound standing may be referred to as being a good covenant.

Curtilage	The ground that is used for the enjoyment of a building.
Damages	Money recoverable by a court action by a person who has suffered loss as a result of a breach of contract or a breach of duty. The amount recoverable depends on the basis of the claim. Damages for a breach of contract will be the amount necessary to put the person suffering the loss back into the position that they would have been in had the breach not occurred.
Dilapidations	Items of disrepair that arise because of a breach of repairing covenants on the part of the tenant or landlord. It is usual for the dilapidations for which the tenant is liable to be listed in a 'Schedule of dilapidations', which can be served on the tenant at any time during or within an agreed period of time (eg, two months) of the end of the lease..
Disregards	Items that are disregarded and so not taken into account in assessing the value of the property. For example, a lease will usually list a number of matters that are not be taken into account in assessing the rent on a review, such as the fact that the tenant has carried out some improvements to the property (in this example this is important to the tenant so that it does not pay for both the capital cost of the works and then the increase in rental value).
Easement	A right enjoyed by a person over the – usually neighbouring – land of another, or a right to limit the enjoyment of the owner over their land. For example, a right of way would entitle one party to pass over the land of the other. A right of drainage would give one party the right to allow water to drain from their land on to or through the land of the other. A right to light would restrict one party from doing anything on their land that would hinder the access of light to the property of the other.
Engrossment	The formal and final version of a legal document, prepared by a solicitor for signature, once the contents have been negotiated and agreed.
Fixture	Chattels or goods that have been fixed to the land or building so as to become part of that land or building so that ownership passes with the property. A fixture is different from a fitting, which because of its nature and the purpose and method of fixing to the land or building does not become a fixture. Ownership of a fitting does not pass with the land.
Forfeiture	The right of the landlord to retake physical possession of the land and bring the lease to an end because of a breach of covenant on the part of the tenant.
Headlease	A lease held directly from the freeholder, which may be subject to one or more underleases.
Indexation	The automatic adjustment to a rate, price or payment in line with variations in a specific index, eg, the Retail Prices Index, usually to maintain the value of an asset in line with inflation.

Land Registry	The government body that records the ownership and interests in all registered land in England and Wales. The register states the registered title number, includes a plan of the property, and will provide full details of the owner of the land and of all registerable rights benefiting the land and to which the land is subject, including if the property is subject to a mortgage or charge.
Latent defect	A defect that is inherent in the design or construction of a building, and which is not immediately apparent and could not be discovered on an inspection carried out on completion of the building works.
Licence	The lawful grant of a right or a permission to do something that would otherwise not be legal or allowed. The person granting the right is called the licensor and the person to whom the right is granted is called the licensee.
Lien	The right to retain possession of the property of another as security for the performance of an obligation, generally the payment of a debt.
Open market value	The price that it might be reasonable to expect to achieve from an unconnected third party for an interest in property at the date of valuation.
Option	A unilateral right created by contract, giving one party the right at some future date either to exercise a right to do something or to require a party to do or not do something.
Outgoings	The costs and expenses incurred by the owner or occupier of a property in connection with its ownership, use, management and maintenance.
Party wall	The wall separating the properties of two adjoining owners, each of which will have certain rights over the wall.
Peppercorn rent	A token rent payable to a landlord under a lease, usually where a premium has been paid for the lease. The existence of a rent, however small, preserves certain rights from the landlord. Usually the rent is of a nominal amount, eg, £1.00, but could literally be a peppercorn (this term has historic meaning).
Portfolio	Collection of properties or other investments held under one ownership.
Possession	Control over land or buildings, either by occupation and use, or in the case of a landlord, by the right to receive rents, if any, and to exercise the rights and duties in connection with the lease.

Practical completion	The time under a building contract when the building is said to be complete in almost all respects and ready for occupation, save for minor defects that can be put right after the development has been handed over without undue interference or disturbance to the occupier. The surveyor, or other supervising officer, will issue a certificate of practical completion, which is a signed statement confirming that in their professional opinion practical completion has been achieved. Once practical completion has been achieved, the owners of the building take responsibility for it and must insure it. Practical completion also usually triggers the release of funds, commencement of any period of defects maintenance and the commencement of any occupational leases.
Pre-emption	A right of first refusal, whereby if the owner of a property decides to sell, the owner must first offer to sell the property to the holder of the pre-emption right.
Pre-let	A legally enforceable agreement for a letting to take effect at a future date, eg, on the practical completion of building works.
Prescription	The acquisition of a right by the unrestricted and continuous exercise of that right for a prescribed period of time. For example, the unauthorised use of a particular access route, without objection or interruption, over a period of 20 years (or in some cases 40), gives the person using that access route the right to use it. Similarly, unauthorised possession of property for a continuous and uninterrupted period of 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.
Priority of mortgages	Where there are two or more mortgages secured on a property, the order in which they are discharged by repayment to the extent that funds are available on a sale of the property or the default of the borrower.
Quarter days	In England and Wales the days that traditionally are designated in a lease for payment of instalments of rent, being Lady Day – 25 March; Midsummer – 24 June; Michaelmas – 29 September; Christmas Day – 25 December. Local authorities may use 1 January, 1 April, 1 July and 1 October. In Scotland the quarter days are known as term days and are 2 February, 15 May, 1 August and 11 November.
Quiet enjoyment	The right of a tenant to be given possession of the entire property leased to them and to enjoy the property without physical interference from their immediate landlord.
Rack rent	A rent representing the full, or nearly the full, letting value of the property on a given set of terms and conditions.
Sale and leaseback (or lease and leaseback)	An arrangement whereby a freeholder or a tenant sells their interest in a property for an agreed sum, and takes back a lease of the whole or part of the property from the buyer. It is a device usually used to unlock and make available capital invested in a property.

Service charge	The amount payable by a tenant under a lease in respect of the services provided by the landlord.
Surety	A person who offers security for the payment of a debt or the performance of an obligation. A landlord may require a surety, or a guarantor as otherwise known, to guarantee the **tenant's obligations** under the lease, including the obligation to pay rent.
Surrender	The return of the lease to the landlord by the tenant before the contractual expiration date of the lease. The tenant may have to pay the landlord a surrender premium or price for being able to bring the lease to an end early. Sometimes the landlord wants the lease to be surrendered and will be willing to pay the tenant a premium, known as a reverse premium, for the benefit of having the lease ended and the property returned at an earlier date.
Zoning	The division of an area into zones for particular uses or activities. This may be done, eg, by a local authority as a part of its planning policy, whereby particular land uses are designated to certain areas of a locality. Zoning is also the method used to arrive at the rental value of a retail space, usually on the ground floor, by dividing up into strips parallel with the main frontage. A different value per unit of space is attributed with each strip corresponding to its relative ability to achieve sales and/or profit. The most valuable space is usually towards the front.

Municipal tax system in the United Kingdom

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. Revaluations are normally carried out every five years with the most recent one in England, Wales and Scotland taking effect from 1 April 2010. The next will come into effect from 1 April 2017 based on annual rental values as at 1 April 2015. 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 2015/16 is 49.7% of rateable value. This means that a factory with a rateable value of £1m would pay rates of £497,000 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 £55,000 in London. 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 £2,600.

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.

Contacts

Tax

Rob Walker
Tel: +44 (0)20 7212 2324
E-mail: robert.j.walker@uk.pwc.com

Paul Emery
Phone: +44 (0)20 7213 3071
E-mail: paul.emery@uk.pwc.com

Greg Powell
Tel: +44 (0)20 7804 2594
E-mail: greg.j.powell@uk.pwc.com

Tim Jones
Tel: +44 (0)20 7212 5450
E-mail: tim.j.jones@uk.pwc.com

Richard Dalton
Tel: +44 (0)20 7213 1551
E-mail: richard.j.dalton@uk.pwc.com

Helen Whitfield
Tel: +44 (0)20 7804 2752
E-mail: helen.l.whitfield@uk.pwc.com

Sandie Morgan
Tel: +44 (0)121 265 5494
E-mail: sandie.e.morgan@uk.pwc.com

Stephen Gent
Tel: +44 (0)20 7804 1530
E-mail: stephen.p.gent@uk.pwc.com

Legal

William Seymour
Tel: +44 (0)20 7212 1602
E-mail: william.h.seymour@pwclegal.co.uk

www.pwc.com/goingglobal

Real Estate Going Global United States of America

Tax and legal aspects of real estate investments around the globe

2016

pwc

Contents

Contents 2

Real Estate Tax Summary – United States of America 3

Real Estate Investments – United States of America 6

Contacts 35

All information used in this content, unless otherwise stated, is up to date as of 7 June 2016.

Real Estate Tax Summary – United States of America

General

A foreign investor may invest in US real property directly, or through a domestic or foreign partnership, limited liability company or corporation.

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 2016 of 3% for corporations and 39.6% 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, deductions for interest on loans made or guaranteed by related foreign persons may be deferred to the extent not paid, 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 amortizable over 15 years.

Net Investment Income Tax

Starting in 2013 the US passed 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 35% 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 2016, 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 35% on the corporation's effectively connected income (ECI). The combined effective rate of income tax and BPT is up to 54.5%. 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. The unused operating losses may be carried back two years, and forward 20 years.

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 35% of the amount of such income that is allocated to a foreign partner. Lower rate of 20% and 25% apply to capital gains of partners that are foreign individuals or trusts under US tax principles.

State and local income, franchise and property, and transfer taxes may also be due.

Real Estate Investments – United States of America

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 alternative minimum tax (AMT) that may apply to US business income, 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 2016, the maximum tax rate for US citizens or residents is 39.6% and for corporations is 35%.

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 35% tax on its income, and the remaining profits are subject to the 30%, the effective tax rate upon remittance to the shareholders is 54.5%, 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 35% federal income tax saving. The rate of 35% 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. 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 54%.

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 35% tax on the distribution. However, exceptions to this 35% 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, ie, effectively connected income (ECI). The computation of taxable income and the applicable tax rates are quite different if the income is not effectively connected with a US business.

Defining the terms 'US business' and 'ECI'

The Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) provides that gains and losses from the sale or exchange or other disposition of US real property interests, including the stock of a US corporation when the majority of its assets are US real property interests, will automatically be considered ECI, irrespective of whether the US real estate investment constitutes a business to the foreign owner.

Facts and circumstances test

A facts and circumstances test applies in determining whether operating income, such as rental income, is income effectively connected with a US business. For purposes of ease, income effectively connected with a US business is also described as 'business income.'

A foreigner's investment in US real property will generally constitute a US business, as opposed to a non-business or passive investment, if the foreigner is carrying on the management or other operating activities on a regular basis, either directly or through an agent. Therefore, the purchase and subsequent development of a parcel of

land for purposes of resale would normally constitute a business. Also, the ownership and leasing of one or more properties could constitute a US business. However, the rental of property on a net lease basis to one or a small number of tenants is generally not considered 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 2016 are 39.6% and 35%, 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 35% 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 allow the 35% withholding rate to be reduced 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.
- The earnings stripping rules, discussed below, may apply.
- The earnings stripping rules provide that a corporation's deduction for interest expense will be limited if the following conditions exist:
- The corporation's debt-to-equity ratio exceeds 1.5:1; and
- The corporation's net interest expense exceeds 50% of its adjusted taxable income; and either:
- The payee is a related person that is subject to a reduced rate of tax, or no tax, on the interest income, eg, where the 30% tax is reduced or eliminated because of a treaty or the portfolio debt rules; or
- The payee is an unrelated person that has obtained a guarantee from a foreign person related to the borrower. This rule does not apply if the interest would have been considered US business income had it been paid to the foreign guarantor.

Adjusted taxable income for this purpose is generally the taxable income of the corporation before any deduction for interest expense, depreciation, amortisation, depletion and any net operating loss.

If a foreign corporation's only business activity is the US real property, the determination of the amount of interest expense allowable as a deduction is fairly straightforward, subject to rules such as those above. The deductible amount should generally be that shown on the books and records. However, if the foreign corporation also has assets that are not connected with a US business, then the corporation's total worldwide interest expense must be apportioned between US business income and other income. An analysis of these rules is beyond the scope of this discussion.

The determination of interest allowable as a deduction by a foreign corporation is also important because the excess of the interest allocable to a foreign corporation's ECI, over the amount actually paid, is subject to a 30%, or lower treaty rate, US tax.

Special rules also apply to the determination of interest expense allowable as a deduction to non-resident aliens (NRAs). With respect to assets owned directly by an NRA, no interest deduction is allowed to the extent it is generated by debt that exceeds 80% of the NRA's US business assets. With respect to partnerships, if the NRA owns less than a 10% limited partnership interest, then no interest expense incurred directly by the NRA is allowable as a deduction. For other partnership interest categories, special look-through rules apply that are beyond the scope of this discussion. Interest expense directly incurred by an NRA may not be allocated to ECI derived by a partnership and allocated to the NRA.

As previously mentioned, in 1995 the US Treasury Department issued regulations in an attempt to prevent the use of conduit entities by foreign persons to avoid or reduce US tax.

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 organizations 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 depreciation rules differ for purposes of the alternative minimum tax (AMT), thereby possibly requiring foreign corporations to recalculate or keep track of depreciation allowable, and the adjusted tax basis of assets under at least four methods (the method used for books, the regular tax method, the AMT method, and the method used for earnings and profits that is relevant for BPT purposes).

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 installment sales rules, the concept of original issue discount, and the rule requiring that installment 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*'.)

Installment sales

Nevertheless, 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 installment method of reporting. There is an exception to this rule if certain recapture provisions apply.

Because the installment 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 installment 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 installment 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 installment 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 installment gains, even if they no longer have any other business connection in the year the payments are received.

Special rules apply when installment 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 installment 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.

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.

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 installment 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.

If the stated principal amount of an instrument is less than US$2.8m, and the transaction is not a sale-leaseback, and the property transferred is not investment

credit property, then the discount rate to be used for purposes of these rules is the lesser of 9% compounded semi-annually, or the AFR.

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 January1993 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.

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 effected 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, ie, 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.
- 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 corporations, 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.

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 54.5% of its gain from the sale of a US real property.

BPT generally applies to foreign corporations that earn business income, or income treated like business income by virtue of a net basis election, through a US place of business, ie, a branch. For these purposes, income and gains realised by foreign corporations from US real property, excluding gains from the sale of stock in a US real property holding corporation, are treated as business income earned through a US place of business. BPT may not apply, however, to a foreign corporation that qualifies as a resident of a country that has an income tax treaty with the US that eliminates the tax.

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 in 2.4.5, 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 installments or deferred payments from the sale of a USRPI, unless the seller elects not to have the installment 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 organization or arrangement which is:

- Created or organized under the law of a country other than the US,

- Established to provide retirement or pension benefits to participants or beneficiaries that are current or former employees (or persons designated by such employees) of one or more employers in consideration for services rendered,

- Does not have a single participant or beneficiary with a right to more than 5% of its assets or income,

- Subject to government regulation and provides annual information reporting about its beneficiaries to the relevant tax authorities in the country in which it is established or operates, and

- With respect to which, under the laws of country in which it is established or operates,

- Contributions to such trust, corporation, organization, or arrangement which would otherwise be subject to tax under such laws are deductible or excluded from the gross income of such entity or taxed at a reduced rate, or

- Taxation of any investment income of such trust, corporation, organization or arrangement is deferred or such income is taxed at a reduced rate.

- If the seller is a QFPF, or a wholly owned entity of a QFPF, the gain or loss shall not be treated as income effectively connected with a US trade or business.

Interests in Real Estate Investment Trusts (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 recognized 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 recognized stock exchange,

- Is a qualified collective investment vehicle, and
- Maintains records of persons which owns 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 10% 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 installment 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 10%, and reducing their future installments 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 35% (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 35% (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 35% 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 10% 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$ 14,000 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$5m from US estate tax, the estate of an NRA is entitled to a credit equivalent to only a US$ 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.

Contacts

Advisory

Byron Carlock, Jr.
US Real Estate Practice Leader
Tel: +1 214 7547580
E-mail: byron.carlock.jr@us.pwc.com

Tapan Nagori
US Real Estate Advisory Leader
Tel: +1 312 2983574
E-mail: tapan.nagori@us.pwc.com

Assurance

Tim Conlon
US Real Estate Clients and Markets Leader
Tel: +1 646 4717700
E-mail: timothy.c.conlon@us.pwc.com

Richard Fournier
US Real Estate Assurance Leader
Tel: +1 617 5307168
E-mail: richard.e.fournier@us.pwc.com

Jeff Kiley
US Private Equity Real Estate
Tel: +1 646 4715429
E-mail: jeff.kiley@us.pwc.com

Tax

Paul Ryan
US Real Estate Tax Clients Markets Leader
Tel: +1 646 4718419
E-mail: paul.ryan@us.pwc.com

David Voss
US Real Estate Tax Leader
Tel: +1 646 4717462
E-mail: david.m.voss@us.pwc.com

Tom Wilkin
US REIT Leader
Tel: +1 646 4717090
E-mail: tom.wilkin@us.pwc.com

This publication has been prepared for general guidance on matters of interest only, and does not constitute professional advice. You should not act upon the information contained in this publication without obtaining specific professional advice. No representation or warranty (express or implied) is given as to the accuracy or completeness of the information contained in the publication, and, to the extent permitted by law. PwC does not accept or assume any liability, responsibility or duty of care for any consequences of you or anyone else acting, or refraining to act, in reliance on the information contained in this publication or for any decision based on it.

© 2016 PwC. All rights reserved. Not for further distribution without the permission of PwC. “PwC” refers to the network of member firms of PricewaterhouseCoopers International Limited (PwCIL), or, as the context requires, individual member firms of the PwC network. Each member firm is a separate legal entity and does not act as agent of PwCIL or any other member firm. PwCIL does not provide any services to clients. PwCIL is not responsible or liable for the acts or omissions of any of its member firms nor can it control the exercise of their professional judgment or bind them in any way. No member firm is responsible or liable for the acts or omissions of any other member firm nor can it control the exercise of another member firm’s professional judgment or bind another member firm or PwCIL in any way.

www.pwc.com