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# Main tax aspects of real estate investments in Romania

Bucharest Meeting Point
1 – 3 July 2008

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# Overview

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- Changes in VAT legislation affecting real estate transactions in 2008
- Financing issues: debt vs. equity
- Taxation on exit – Asset deals vs. Share deals
- Dividends taxation – latest developments
- Case study
- Key tax issues for residential projects
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# Changes in VAT legislation

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# Elimination of VAT simplification measures

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- **In 2007, the provided the application of a reverse charge system on the following types of transactions carried out between entities registered for VAT purposes:**
  – Sales of real estate (i.e. land, buildings or parts thereof); and
  – Construction works.
- The simplification measures mentioned above have been abolished as of 1 January 2008.

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# Elimination of VAT simplification measures

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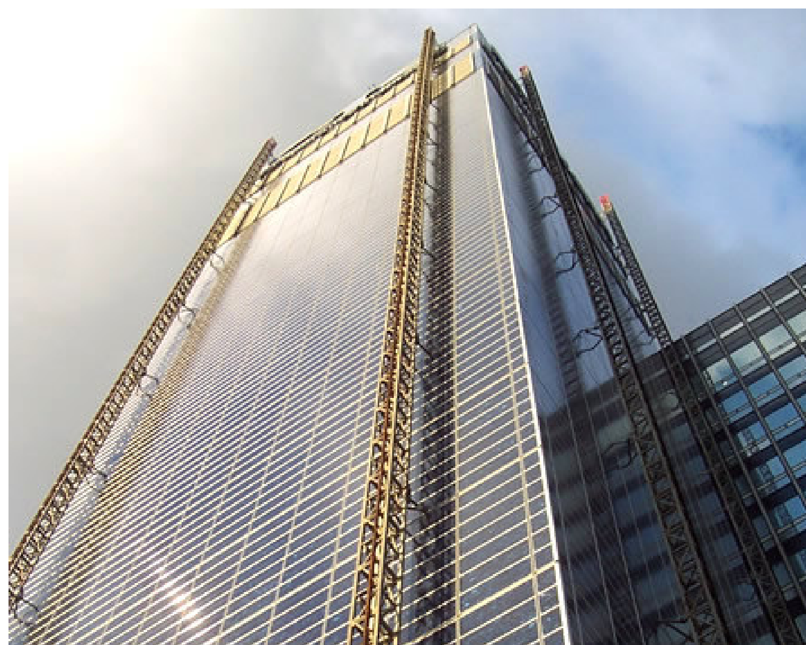
- **Effects of simplification measures under the previous legislation:**
  - Construction companies had little or no output VAT collected on their sales, so input VAT incurred had to be reclaimed directly from the state budget;
  - Constant VAT credit positions had put significant pressure on the cash-flows of construction companies, as VAT reclaims are usually lengthy processes and thus input VAT required extensive financing;
  - VAT simplification measures did present advantages to real estate developers and final beneficiaries of real estate projects, as VAT did no longer pose cash-flow and financing problems for them.



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# Elimination of VAT simplification measures

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- **Effects of elimination of simplification measures as of 1 January 2008:**
  - Construction companies no longer have an input VAT financing issue;
  - The matter of financing the input VAT on real estate acquisitions has been shifted to final customers, as they now need to pay the acquisition price with VAT and offset / reclaim such input VAT later.

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# VAT refund process

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- Under the Romanian rules, the VAT refund procedure imposes undergoing a prior official VAT audit – this should theoretically take no more than 45 days to complete, but in practice this deadline is significantly exceeded (in some cases up to 12 months);
- In terms of procedure, companies claiming a refund of the VAT credit simply need to tick the appropriate box in the VAT return; once requested for refund, that amount cannot be carried forward in the next VAT returns to be offset against future output VAT.

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# VAT on real estate transactions carried out by individuals

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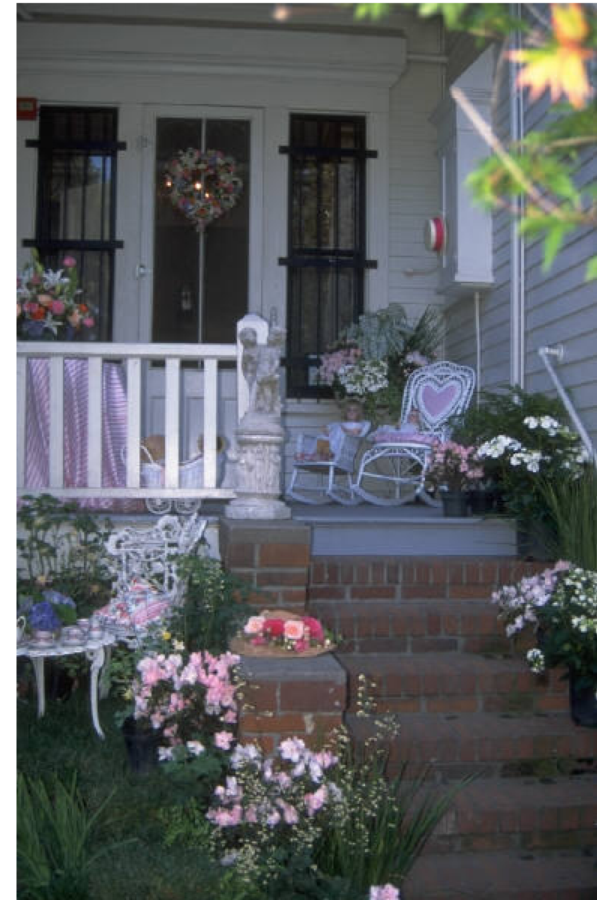
- **As of 1 January 2008, Romanian authorities started scrutinising real estate projects developed by individuals, from a VAT perspective.**
- Under the definition of the taxable person given by the Romanian Fiscal Code, anyone (including individuals) carrying out economic activities (i.e. activities with a certain degree of continuity and aimed at deriving profits) of an independent manner is seen as a taxable person from a VAT perspective and thus is required to collect VAT on its output transactions, where such VAT applies.



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# VAT regime of sales and rental of real estate

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- **As of 1 January 2007, the VAT regime applicable to real estate transactions is as follows:**
  - Sale of new buildings and buildable land is subject to VAT at 19% (no reduced rate is applicable upon sale of residential buildings);
  - Sale of old buildings and non-buildable land is by default exempt from VAT without credit for input tax, but the seller may opt to charge VAT on the sale;
  - Rental and leasing of real estate (irrespective whether it concerns new or old buildings) is by default exempt from VAT without credit for input tax, but the landlord/lessor may opt to charge VAT on such transactions.

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# Financing issues: debt vs. equity

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# Financing issues: debt vs. equity

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- **Equity financing**
  - no capital duties;
  - requires registration with the Romanian Trade Registry (minimum fees charged);
  - withdrawal of share capital requires completing a formal legal procedure that takes around 3 months to complete
  - **dividends** – 16% vs. 10%, EU Parent Subsidiary Directive, Double Tax Treaties
- **Debt financing**
  - no capital duties;
  - may require notification and on-going statistical reporting with the National Bank of Romania;
  - **interest** - thin capitalization rules applicable for interest deductibility; transfer pricing rules apply for shareholder loans; withholding tax applies upon payment of interest to a non-resident lender.

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# Thin capitalization rules

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- **Interest rate deductibility cap:**
  - 7% per annum in 2008, for EUR or USD denominated loans. Please note that this interest rate limitation is revised annually, and therefore the 7% cap may change in the future;
  - For RON denominated loans, a quarterly interest rate limitation is applicable for each loan for corporate income tax purposes. The quarterly limitation is the reference interest rate communicated by the National Bank of Romania ("NBR") for the last month of each quarter.
- **Thin capitalization rules**
  - Applied after the interest rate capping test;
  - Debt-to-equity threshold: 3:1 – if exceeded or negative, interest is not deductible in that given year, but may be carried forward to be deducted in future years (as soon as the debt-to-equity ratio falls below 3:1).
  - bank loans not considered; loans/debts over 1 year considered.

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# Taxation of asset deals vs. share deals

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# Asset deals vs. share deals

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- **Asset deals by Romanian companies holding real estate:**
  - **Capital gains** derived by a Romanian company from the sale of real estate assets are subject to corporate income tax at **16%** at the time of the sale;
  - Repatriation of profits derived from an asset deal to foreign shareholders of the Romanian company triggers **taxation of dividends** - rate applicable under the Romanian – Spanish Double Tax Treaty is 10% (for legal entities holding over 25%) or 15% (in all other cases); more beneficial treatment may be granted under the EC Parent Subsidiary Directive.
  - **Notary fees** fall due upon the transfer of ownership over the real estate.

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# Asset deals vs. share deals

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- **Tax depreciation – useful lives to be used for tax purposes:**
  - industrial buildings (except buildings used in the foods industry, construction materials industry, chemical industry and metal industry: 40 – 60 years
  - residential buildings: 40 – 60 years
  - office buildings: 40 – 60 years
  - shopping and distribution centres: 32 – 48 years
  - warehouses: 24 – 36 years
- **Certain items incorporated in a building may be depreciated separately, on condition that their cost is capitalised separately for accounting purposes as well**

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# Asset deals vs. share deals

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- **Revaluations – general rules:**
  - Potential benefits may arise from **revaluations** of buildings prior to sale, as revaluations made after 1 January 2007 are taken into account for tax purposes.
  - Buildings and land held for re-sale (i.e. as current assets) cannot be revalued, but only real estate held as non-current assets (e.g. held for rental).
  - Revaluations must be carried out at the end of the year, as per the Romanian accounting rules.
  - Step-up in tax value of real estate is allowed provided revaluation is performed appropriately under accounting regulations.

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# Asset deals vs. share deals

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- **Revaluation benefits:**
  - Potential reduced tax rates on local taxes (0.25% - 1.5% compared to 5% - 10% applicable if no revaluation is performed for a 3-year period).
  - Deduction of higher depreciation charges for corporate income tax purposes.
  - Postponement of taxation of revaluation reserves in the event of a sale of the corresponding real estate – revaluation reserves are transferred to retained earnings and only taxed upon distribution as dividends or in any form to the shareholders.

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# Asset deals vs. share deals

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- **Share deals**
  - Under the Fiscal Code, capital gains derived from the sale of shares in a Romanian real estate company are taxed in Romania (at 16%). However, some of Romania's Double Tax Treaties give taxation rights only to the country of the residence of the shareholder earning the gains and may optimise taxation;
  - Shareholding structures are important in the context of real estate investments, as they determine taxation upon exit via a share deal, as well as the level of net profits after tax during the holding period;
  - No notary fees payable, as real estate does not change ownership further to share deals.

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# Asset deals vs. share deals

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- **Share deals in the context of the Romanian – Spanish Double Tax Treaty**
  - Capital gains from the sale of shares in Romanian real estate companies held by Spanish entities are taxed only in Spain, as per the provisions of the Romanian – Spanish Double Tax Treaty.
  - Please note that other Treaties may contain specific provisions to allow Romania to tax capital gains from sale of shares in Romania real estate companies, so shareholding structure is essential to plan ahead.

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# Latest developments in taxation of dividends

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# Latest developments in taxation of dividends

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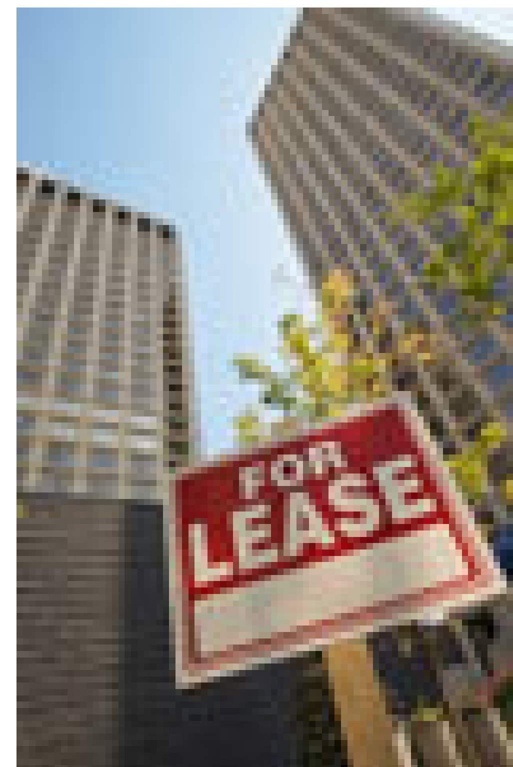
- As many investors in Romanian real estate are foreign companies or individuals choosing to invest via a Romanian special purpose vehicle, taxation of outbound dividends is important.
- Currently, the Romanian Fiscal Code provides a **10%** tax rate for dividends distributed to Romanian corporate shareholders, compared to a (general) **16%** tax rate for dividends distributed to foreign corporate shareholders. Such treatment has been regarded as discriminatory under the EU and EEA Treaties and an infringement procedure has been recently initiated against Romania in this respect.
- Romania took action to correct this situation by amending the Romanian Fiscal Code (via Emergency Ordinance 91 published on 30 June 2008 and coming into force as of **1 January 2009**) to bring withholding tax rates applicable upon distribution of dividends to EU and EEA corporate shareholders to **10%** - the same rate as for domestic dividends.

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# Latest developments in taxation of dividends

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- Separately, the EU Parent Subsidiary Directive (exemption from dividend tax) applies with regard to EU corporate shareholding entities in given conditions (minimum 15% (10%  from 2009) holding for minimum 2 years) and various Double Tax Treaties may also apply to reduce the tax rate on dividends.
- Still as a result of the infringement procedure recently initiated against Romania with respect to discriminatory treatment of EEA (i.e. Island, Norway and Liechtenstein) tax resident corporate shareholders, the exemption from dividend tax under the conditions set out in the EC Parent Subsidiary Directive would equally be granted to EEA tax resident corporate shareholders  as of **1 January 2009.**

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# Case study

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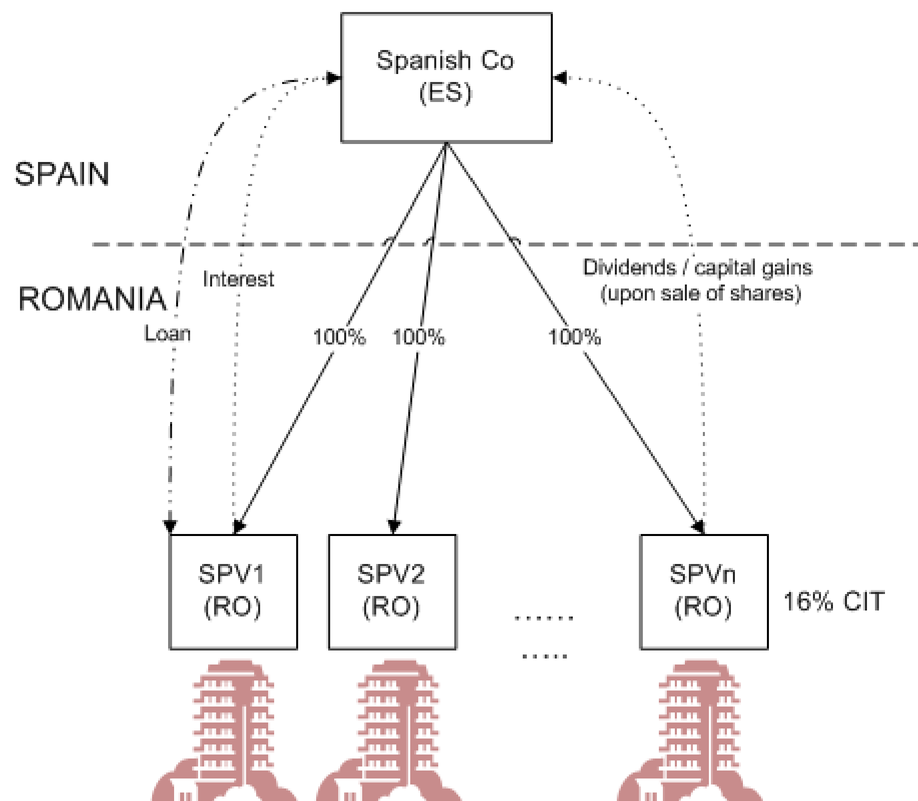
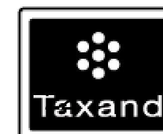



- **Profits**
  - Profits derived by each SPV from sale of residential units / rental of office / commercial space are taxed at 16%;
  - Sale of new residential units is subject to VAT at 19%
- **Interest payments**
  - WHT at 10% (under the Romanian – Spanish Treaty). As of 1 January 2011, no withholding tax would fall due assuming that SpanishCo owns at least 25% of each of the SPVs for an uninterrupted period of at least 2 years.
- **Dividend payments**
  - WHT at 10% in the first 2 years; no WHT after the first 2 years under the E Parent – Subsidiary Directive
- **Capital gains**
  - No capital gains tax in Romania – as per the provisions of the Treaty

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# Key tax issues for residential projects

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- **VAT**
  - In principle, VAT at 19% should be charged on all sales of new residential units, irrespective whether the project is developed by a company or by an individual
  - Given the practical difficulties encountered in obtaining a refund of input VAT, real estate developers should take into account that input VAT incurred during the investment phase may need to be financed until selling the residential units – at which time input VAT is normally offset against output VAT on sales.
- **Corporate income tax**
  - The benefits of revaluations may not be used in residential projects, as in these cases the buildings are intended for sale and thus do not constitute non-current assets, hence may not be revalued for accounting purposes.
- **Exit scenarios**
  - The alternative of a share deal as an exit scenario is not often practicable in the context of residential projects. Under an asset deal, taxation of profits derived from the sale of residential units may not be deferred, as revaluations may not be an option. In addition, dividend taxation needs to be considered for repatriation of profits in such projects.

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