

TAX CONSIDERATIONS ON REAL ESTATE
GGI European Conference - International Tax Group

For additional information, please contact:
Ionut Zeche, Partner
izeche@mirus-group.eu

Investing in Properties

Foreign investments in real estate in Romania are typically made either by setting up a local company (legal entity) which then purchases properties, or by acquiring a local corporate vehicle owning real estate.

Sale and purchase of real estate properties located in Romania are subject to notary fees and in certain cases to judicial stamp duty. A **judicial stamp duty** is charged as a percentage of the value of the transaction (the marginal rate is approximately 1% for transactions with values exceeding approximately EUR 55,000), while a **notary fee** could be of around 0.5% of the value.

In case of alienation of property rights over buildings and land (*inter-alia*), taxpayers must have available a fiscal certificate issued by the local tax authorities attesting the payment of all related local taxes. In case of non-compliance with this requirement, the transfer of such assets would be null and void.

Starting 1 January 2007, the **VAT** legislation changed significantly as compared to 2006, due to the harmonization with the EU 6th VAT Directive. Under the new rules, not all transactions with immovable goods are taxable with 19% VAT. As of 1 January 2007, a sale performed by any person of old buildings/parts of buildings and the underlying land, as well as of any other type of land will be VAT exempt without credit. However, any taxable person performing such transactions may opt to tax the sale of these immovable assets with 19% VAT. Please consider that the above mentioned exemption will *not* normally be available in case of the sale by a taxable person of a new building/parts of a new building or of land on which buildings can be erected. In such case the normal VAT regime would be applicable.

When VAT is charged, special VAT simplification measures apply in case of acquisition of land and buildings (or parts of buildings), provided both the seller and the buyer are registered in Romania for VAT purposes. Specifically, these measures imply the application of VAT through the reverse-charge mechanism, under which the buyer would account for both input and output VAT without any VAT cash flow implications.

Financing of Real Estate Acquisitions

A local company acquiring and operating real estate may be financed either by equity or debt financing.

Equity financing would normally be tax neutral, while for loan financing the following tax implications should be considered.

From a **profits tax** perspective, under the current thin capitalization rules, there are certain restrictions on the deductibility of interest expenses and related foreign exchange losses. Usually, interest expenses incurred by companies on loans obtained from other sources than banks and financial institutions are subject to the following Limitations:

- **Debt-equity ratio** – interest expenses are deductible if the debt-equity ratio is lower than or equal to 3:1. In case such

ratio is higher than the aforementioned limit, interest expenses are non-deductible for profits tax purposes and can be carried forward until they are fully deductible under the same conditions. Also, the difference between foreign exchange losses and foreign exchange revenues relating to long-term loans is treated as interest expense and is subject to the debt-equity ratio limitation.

• **Interest rate** (for loans granted by companies other than banks and financial institutions) – interest is deductible within the following rate limits:

- The reference interest rate of the National Bank of Romania in the last month of the quarter, for loans denominated in RON (currently of approximately 8.75%);
- The annual interest rate of 6% for loans denominated in foreign currencies - such interest rate level is to be updated periodically by Government Decision.

The non-deductible portion of the interest cannot be carried forward.

Interest expenses as well as the foreign exchange losses related to loans obtained from domestic or foreign banks and other legal entities which may grant credits according to the law are not subject to the thin capitalization rules.

In intra-group financing transactions, the transfer pricing regulations should be observed with regard to the interest rate level.

In case of financing obtained from abroad, the **withholding tax** of 16% will apply to the interest income derived by the non-resident. Such tax may be reduced (even to nil) under the provisions of some of the double tax treaties with other countries, to which Romania is a party, in case a tax residency certificate of the beneficiary is available to the Romanian payer of interest income at the moment of income payment. Also, the provisions of the Interest & Royalties Directive implemented in the Romanian legislation starting 1 January 2007 (with a transitory period until 31 December 2010) should be considered. Under the provisions of the Directive implemented in the Fiscal Code, interest payments would be exempt from withholding tax in Romania provided certain conditions are met (namely a 25% shareholding in the Romanian entity for at least 2 years ending when the interest income is paid). However, during the transitory period the withholding tax rate for interest would be of 10% as long as the same conditions are met.

However, in some cases, finance leases of real estate may carry interest which is subject to VAT.

Loans received by Romanian legal entities (either from related parties or other financial institutions) and related interest are not subject to **VAT**.

Operational Phase

From a **profits tax** perspective, local entities will tax the rental income related to the immovable property at the standard profits tax rate of 16% and will be allowed to claim tax depreciation charges of the real estate based on the acquisition price. Land, however, is a non-depreciable asset, but costs incurred with land improvement may be depreciated from a tax perspective (straight-line depreciation for a period of 10 years).

Depreciation for tax purposes may be different from accounting depreciation. Any revaluation of real estate is taken into account for tax depreciation purposes/for establishing the fiscal value of the land. The typical depreciation period for buildings ranges between 40 to 60 years.

Although rental of immovable property is normally VAT exempt without credit, legislation allows the landlord to opt for charging **VAT** on rentals. It is important to note that rentals exempt from VAT may negatively affect the input VAT incurred by the landlord on acquisition or construction of the real estate due to retroactive VAT adjustment.

Separately, owners of buildings should pay an annual **building tax** to the local authorities. For companies, such building tax would range between 0.25% and 1.5% of the book value of the building. The building tax may increase to up to 10% if the building has not been revalued for 3 years. Land owners are liable to pay the **tax on land**, which is established as a fixed amount per unit of surface, depending on the location of the land. Building tax and land tax are payable in two equal installments by 31 March and 30 September.

MIRUS

Tax, Audit and Advisory Services
16 Dr. Petre Herescu Street, Sector 5 Bucharest 050587, Romania
Phone: +40 (31) 405 1017 Facsimile: +40 (31) 405 1018
www.mirus-group.eu

Local councils may grant exemptions from the payment of building and land taxes to legal entities performing investments exceeding EUR 500,000 for a period of up to 5 years, inclusively.

Depending on the circumstances, for constructions in progress, a contribution to the Social House of Constructors computed as 0.5% of the value of the construction budget (*deviz de constructii* in Romanian) could become payable to the local council, being borne by the owners/investors.

Dividends paid abroad by a local company from its net profits are subject to a 16% withholding tax in Romania. However, this tax may be reduced or eliminated under the provisions of some of the double tax treaties signed between Romania and other countries.

Starting 1 January 2007, dividends paid by a local company to a legal entity residing in an EU member state are exempt from withholding tax, provided certain conditions are met (the non-resident entity holds at least 15% of the Romanian company's shares and the shares are held for an uninterrupted period of at least 2 years ended at the date of dividend payment). The minimum shareholding threshold will decrease to 10% starting 2009. If the above conditions are not met, the domestic rate would be applied for the dividend payment.

However, if the shareholding period condition is fulfilled at a later stage, the Romanian company would be entitled to benefit from the exemption at that moment and ask for a reimbursement of the withholding tax paid.

Exit Scenarios

To dispose of a real estate investment in Romania, a foreign investor can typically sell its Romanian subsidiary, or the Romanian subsidiary can sell the real estate directly. Based on the existing provisions of the Fiscal Code, non-resident legal entities are taxable in Romania at the standard profits tax rate of 16% for the **capital gains** realized from selling ownership right over a local company.

The legislation puts particular emphasis on application of the above taxation rule to the profits or gains obtained from transfer of shares/participation titles in companies, where 50% or more of the assets' value represents, directly or indirectly, immovable property located in Romania.

Separately, profits derived from direct sale of real estate in Romania are also subject to the standard 16% tax.

Capital gains derived by individuals from disposal of shares in local companies are subject to 16% tax. This tax rate is reduced to 1% for shares held for over 365 days in *listed* companies. Capital gains derived by individuals from sale of buildings with land and land without constructions sold within 3 years from acquisition are subject to 3% tax for transactions up to RON 200,000 (approximately EUR 57,000) and a marginal tax rate of 2% for the difference exceeding RON 200,000. For gains derived by individuals from sale of buildings with land and land without constructions held for more than 3 years, the tax rate is of 2% for transactions up to RON 200,000 and a marginal tax rate of 1% for the difference exceeding RON 200,000.

However, under most of the double tax treaties signed by Romania with other countries, income from sale of shares in a Romanian company is generally subject to tax only in the state where the seller is resident even if most of company's assets are represented by real estate. Income from direct sale of real estate located in Romania does not normally benefit from treaty protection.

Direct sale of real estate is subject to **notary fees and possibly to judicial stamp duty and VAT** as described above, while transfer of shares in a Romanian entity is not.

Above information represents a brief summary of recently published information and is not intended to be advice on any particular matter. MIRUS disclaims liability to any person with respect to anything done in reliance of the context of these publications.

MIRUS

Tax, Audit and Advisory Services

16 Dr. Petre Herescu Street, Sector 5 Bucharest 050587, Romania

Phone: +40 (31) 405 1017 Facsimile: +40 (31) 405 1018

www.mirus-group.eu