Do real estate investments still

Even though one might not find the size of the tax burden among the key factors to be considered when making a decision about real estate investments, it is definitely a significant issue that developers and investors take into consideration when making decisions, regardless of the phase of their project.

When considering real estate investments in Slovakia, which issues are currently most pertinent from the tax perspective? What changes does the Slovak tax system offer to investors in 2012?

The situation on the Slovak market

If a developer does not have sufficient funding, real estate construction is delayed and may eventually be suspended. Banks have started applying significantly stricter rules for granting loans, and a number of planned real estate projects with a weak conception or for which the developer does not have sufficient funding will simply not be built at all.

The prognoses made by specialists deal with "market clean-up". As a result of a decrease in rents and an increase in the complications of accessing funding, some investors are, or will be, forced to sell their projects to stronger players or at least to offer a share in a joint venture.

For those who are considering an investment in Slovak real estate for the first time, it is important to re-emphasize that, in general, since 2004 the Slovak tax system has had a number of attractive features for foreign investors. The tax reform introduced a 19% flat tax and a number of forms of taxation were abolished, including dividend taxation, real estate transfer tax, inheritance tax and gift tax. The real estate tax is classified as a local tax and is considered to be an administrative fee, according to its amount.

One very attractive feature of real estate is the depreciation period. For tax purposes, the depreciation period of buildings and infrastructure is 20 years. Both straight-line and accelerated methods of depreciation are allowed. Some components of buildings have a shorter depreciation time, such as elevators and air-conditioning. An important change applicable from 2012 concerns the abolition of an exception for "leasing depreciation," through which the lessee was able to depreciate the buildings acquired under finance lease in only 12 years. This unfavourable change has unified the conditions for the depreciation of buildings acquired under finance lease with other acquisition forms. However, compared to other countries, a unified depreciation period of 20 years is still very attractive.

Tax planning gains in importance in the very period when the companies seek cost saving possibilities. With respect to investments in real estates, the above mentioned favourable depreciation-related conditions provide an optimum tax treatment.

Is there any space for tax optimization?

At present, everyone makes great efforts to minimize their expenses. Each euro should be spent as effectively as possible, no matter whether it is as a necessary response to the decrease in revenues or only as a preventive measure, as a decrease in revenues in the future cannot be excluded. Tax planning gains in importance in the very period when the companies seek cost-saving possibilities. With respect to investments in real estate, the favorable depreciation-related conditions provide optimum tax treatment.

In addition, there is an option to suspend the depreciation for tax purposes during the depreciation period and thus maximize the possibility to carry forward tax losses. Provided the losses were computed under the generally accepted accounting principles, a loss-carry-forward is granted but limited to seven years. There is no obligation to invest an amount equivalent to the losses carried forward or to carry forward the loss in equal portions. The possibility of a loss-carry-forward is also granted to a legal successor – under the assumption the reorganization form can be justified from an economic perspective.

It is also worth mentioning that Slovakia has no restrictions in the form of "thin capitalization rules." What does this mean for an investor? Provided the investor has sufficient funding and decides to finance the project in Slovakia through a loan drawn from a related company, the Slovak Income Tax Act does not limit the tax deductibility of interest payments subject to the ratio between the equity and the loan granted. However, there is another issue which has to be dealt with: arm's length prices – in this case interest payments – are to be applied and documented.

pay off?

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If the project is or was financed through foreign sources and the loan was granted in a foreign currency, a special provision of the Slovak Income Tax Act on the taxation of unrealized exchange rate gains applies. Where real estate was acquired for the purposes of operative lease, taking into regard the development of the Slovak crown towards the euro in the last decade in connection with the revaluation of a liability from a loan, significant exchange rate gains originated. As there is a possibility not to tax them at the time of the revaluation, these amounts which were not taxed in the past could result in significant tax burdens at present.

How to spend each euro effectively – can VAT help?

The cash-flow topic gains in importance and thus increased attention is being paid to the issue of financing the value added tax, which currently amounts to 20%. During the construction of real estate, it is important to be sure to meet the conditions for a voluntary VAT registration, as no revenues are usually received during the construction. In an attempt to prevent tax evasion, the tax administration has lately tightened the rules of the registration process. When filing the registration, it is necessary to present the business venture. With real estate, the intention to generate taxable rental income in the future must be proven.

In my opinion, group registration for VAT purposes can be of interest for related companies with respect to the cash-flow, since as a result transactions within the group are not subject to VAT. Of course, the group registration is administratively more challenging. However, its benefits can be seen above all in the construction phase when some companies within the group report tax liabilities.

The attraction force of the Slovak tax system is partly neutralized due to the fact that the profits from the sale of shares are generally subject to taxation. However, this disadvantage can be completely eliminated if the sale is conducted between two non-residents.

If a lessee intends to pay VAT-exempt rent (e.g. banks, insurance companies) or to buy a piece of real estate without VAT, upon the acquisition of which the lessor claimed an input VAT deduction, the lessor has to take into consideration that, due to an additional adjustment of the deducted input VAT, such a transaction may result in an additional tax burden for the lessor in the form of a proportional VAT refund. For the sake of completeness, I would like to add that the possibility to apply/not to apply the VAT upon a transfer of a piece of real estate may be made use of after five years following the administrative acceptance of construction work. Based on legal regulations, the lease is exempt, but may be taxed optionally. The sale of newly constructed buildings and plots is subject to VAT at all times.

Can state aid be granted?

If a further argument is added to the location (outside Bratislava) – the use of real estate for the performance of supported activities, e.g. for industrial production – space for state aid considerations or EU-funding can be found. For the purposes of state aid, the investments linked to real estate count as legitimate expenses, though they must be related to one of the supported areas. The following areas come into consideration:

- Industrial production
- Technology centers (research and development)
- Strategic services centers (e.g. software development, customer care centers, headquarters of international corporations)
- Tourism

After fulfilling the conditions set by the Act on the Investment Aid, it is possible to place a request mainly for an indirect corporate income tax exemption up to 80% for 10 years, or, in a lesser degree, a direct subsidy for the acquisition of assets, contribution for the creation of new jobs, or transfer of immovable assets owned by the state/regions/municipalities at a reduced price as part of the state aid. More detailed information on Investment Aid will follow from one of my colleagues in the March/April issue.

Are exit - scenarios possible without taxation in Slovakia?

Indirect ownership through corporations is a widely spread ownership form in Slovak real estate for foreign investors. The attraction force of the Slovak tax system is partly neutralized due to the fact that the profits from the sale of shares are generally subject to taxation. However, this disadvantage can be completely eliminated if the sale is conducted between two non-residents.

In addition, if a merger or a split is considered to be a suitable form of reorganization from the business perspective, I would like to note that from a tax point of view the tax law offers the option to include/not to include the differences originating from the revaluation of the transferred assets into the tax base. The legal successor will continue the depreciation of depreciable assets depending on the method chosen and has the possibility to claim the tax losses of the dissolved company not carried forward. However, at the same time he takes over the deferred tax asset or liability as a result of untaxed exchange rate differences.

As for the direct alienation of real estate located in Slovakia, this transaction is subject to taxation based on the Slovak Income Tax Act .

Conclusions to be made

From the taxation point of view, real estate investments can benefit from the simple tax system with possibilities of tax optimization including fast tax depreciation. There are some sticking points in the VAT area in conformity with EU-law, for which I recommend seeking advice in advance. Foreign investors can reach a final 19% income tax rate and, when applying a suitable exit scenario, make use of an income tax exemption.

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