Deloitte.

15th edition

REal Knowledge Newsletter

Tax pitfalls in PRS sector

We are watching closely the growing interest of investors in the Private Rented Sector (PRS). At the same time we would like to point to the fact that when planning a PRS investment, its tax implications should be considered in advance because tax burdens may significantly impact the profitability of such investments. We are presenting below selected tax issues, which should be taken into account when planning an investment in the PRS sector. When drafting this list, we've focused primarily on matters which differentiate a PRS investment from other standard real estate investments.

When CLAT at 6% rate

As of 1 January 2024, amendments to the act on tax on civil law transactions (hereinafter: CLAT) will come into force, according to which, the purchase by the same buyer of **at least six residential units** or shares in such units, constituting separate properties in one or several buildings erected on a single land property **subject to value added tax,** will be subject to a 6% tax rate on the sale agreement for the sixth and each subsequent such unit in that building or buildings or a share thereof.

It should be noted that the legislator introduced in this new regulation an exception from the existing rule, according to which, transactions subject to VAT are not subject to CLAT.

As announced, the aim of these changes is to prevent the institutional investors from buying out flats on a large scale. However, still in accordance with the proposed provisions, CLAT at a 6% rate should not be applied to transactions for the acquisition of entire residential buildings, companies which hold PRS assets, or forward funding investments.

Acquiring a ready PRS project and appropriate VAT rate

When determining the VAT rate applicable to a given building delivery, it should be noted that what decides about the appropriate VAT rate is the classification of a building to the relevant group based on the Polish Classification of Types of Constructions (PKOB).

The 8% tax rate may be applied, among others, to the delivery of a building, construction, renovation, modernisation, thermo-modernisation, remodelling or maintenance works for structures, or parts thereof included in the social housing programme.

The social housing program includes, among others, single-family residential buildings or residential units up to specified area (300 m2 and 150 m2 respectively) as well as residential buildings (classified in the Chapter 11 of PKOB) and parts thereof - excluding commercial units. Accordingly, the sale of buildings or residential units meeting the above definition will be subject to the 8% VAT rate.

Which VAT rate for provision of basic PRS services

VAT taxation applicable to services, which will be provided using the acquired/constructed real property may significantly impact the profitability of a given PRS project. It is so because it has a direct impact on the investor's ability to recover input VAT on the purchase of real property, construction services or other services and goods in connection with the conducted business activity.

At the same time, the determination of the appropriate VAT rate (VAT exemption, 8% or 23% rate) can be affected by several factors determining the nature of services provided. Indeed, it should be noted that renting a residential property for residential purposes is, as a rule, subject to VAT exemption (with certain exceptions as regards the purchaser of a service), while the provision of accommodation services classified in Section 55 of the Polish Classification of Goods and Services (PKWiU) is subject to the 8% VAT rate. Therefore it is crucial to classify the provided services correctly.

If there is any doubt with regard to a VAT rate to be applied, this may be confirmed by obtaining an **individual tax ruling and/or binding VAT rate information** (a type of procedure will depend on a specific situation). The best would be to confirm the appropriate VAT rate for offered services by obtaining the above-mentioned legal instruments by an investor before the services are provided.

Impact of the rate applied to a PRS basic service on the right to deduct VAT on costs incurred

As a general rule, a VAT taxpayer may deduct input tax to the extent that the goods and services purchased are related to activities subject to VAT (such a right is not available in connection with VAT-exempt activities).

Therefore, as mentioned above, the application of the correct VAT rate for services provided (23%, 8%, or VAT exemption) will affect the deductibility of VAT incurred on the purchase or construction of an investment. Accordingly, the impact of VAT on the profitability of private rented business should be taken into account from the start when developing a financial model for investing in the PRS market.

Where the services provided are subject to VAT, the input tax on the purchase or construction of a building should in principle be recoverable. However, when the services provided are exempt from VAT, then, as a general rule, it is not possible to recover input VAT arising from invoices issued by the seller of a property or suppliers of other goods and services.

It is important to note, however, that **non-deductible input VAT may be tax -deductible cost for CIT purposes for an investor providing rental services classified as VAT-exempt.**

Tax depreciation of residential buildings

As of 1 January 2023, a total exclusion of tax depreciation of residential buildings took effect.

In such a situation, it is particularly important to correctly classify and separate fixed assets at the stage of an investment commissioning or at the time of acquiring an investment through an asset deal, bearing in mind that the exclusion of tax depreciation does not apply to structures or equipment which are fixed assets separate from the building.

It is worth mentioning at this point that the division of buildings into residential and non-residential in the Classification of Fixed Assets is based on the Polish Classification of Types of Constructions (PKOB), and buildings with at least half of their total floor area used for residential purposes are classified as residential buildings. Otherwise, the building is classified as non-residential.

However, if the intended purpose of a building has changed, it is possible to convert a residential building into a non-residential building based on adaptations carried out. In such a case, if the intended purpose of a building has changed as a result of these adaptations, a tax depreciation rate applicable to non-residential buildings may apply for tax purposes following such a change.

Tax on revenue from buildings (so-called minimum tax)

Income tax on revenue from a fixed asset being a building which is owned or co-owned by a taxpayer, **which has been given in whole or in part for use based on a lease, rental or other contract of similar nature** and is located in the territory of the Republic of Poland is 0.42% of the tax base (total revenue from individual buildings less PLN 10 million) on an annual basis.

Depending on the line of business, important issue in determining if a building will be subject to the tax on revenue from buildings is whether the contracts that will be entered into with customers constitute a **lease, rental or other contract of a similar nature.** In particular, the open nature of the reference to "contracts of a similar nature" raises questions of interpretation. This wording of the regulation raises concerns about the application of an extensive interpretation, whereby contracts that have few features in common with a lease or rental contract may be considered to be similar to them and thus buildings used on the basis of such contracts would be subject to the building revenue tax.

The practice of tax authorities and jurisprudence in this matter is still evolving, but the recent judgment of the Supreme Administrative Court in this regard should be treated as favourable. In the ruling of 4 July 2023 (ref. II FSK 71/21), the Supreme Administrative Court ruled that a hotel contract is not a contract of a similar nature to a lease or rental, and therefore the tax on revenue from buildings does not apply in such a case.

Real property tax - what rates to apply

The maximum rates of real property tax that will apply in 2024 have increased once again.

Although large cities, where the PRS market is predominantly present in Poland, may apply by way of a resolution the lower rates of real property tax than those indicated as bound rates in the Act on local taxes and levies, they most often apply the maximum rates in practice.

Increasing real property tax burdens from year to year are a major challenge for the Polish real property market, including the growing PRS sector. Although the cost of real property tax is often passed on economically to a tenant, in effect, as it affects the cost of the overall service, its reduction improves the competitiveness of offering, so we should not underestimate its impact on the PRS investment model.

There is a clear trend for local tax authorities to seek to tax properties rented for residential purposes at the highest real property tax rate associated with conducting the business activity. However, this trend is rather controversial.

Indeed, according to the literal wording of the provision, the concept of "buildings connected with conducting business activity" has a broader meaning than the concept of "buildings occupied for conducting business activity". Furthermore, in the context of the Act on local taxes and levies, the position according to which **residential buildings rented for residential purposes** are only connected with conducting business activity and not directly occupied for conducting business activity (due to fulfilling the residential purpose) seems to be more supported by their literal wording, which should, in principle, allow the application of a lower property tax rate, i.e. the one envisaged for residential buildings. This position has recently been upheld in a favourable judgment of the Supreme Administrative Court of 12 July 2023 (ref. III FSK 250/23), in which the Supreme Administrative Court ruled that the property tax rate provided for buildings used for business activities cannot be applied to a building or residential units in which residential needs are satisfied on a permanent basis.

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