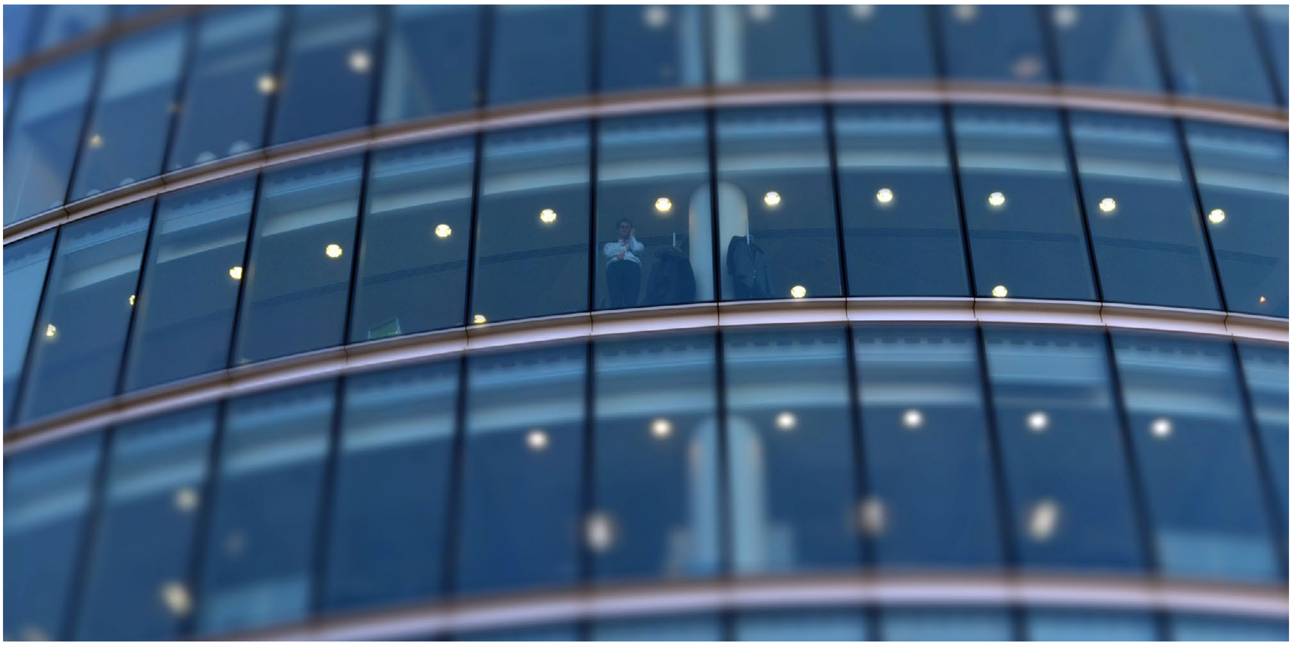

Deferred tax positions in Real Estate investments – different Nordic approaches

Tax regulations in the Nordics generally imply that a transfer of the shares in the property owning company is preferable to a direct asset sale. However, buying shares means inheriting the tax positions of the target company and other possible tax consequences. In the recent years there seems to be an increasing political will to limit the tax benefits of indirect property ownerships and transfers. Here, both actual and proposed new legislation, as well as transactional market practice, differ between the Nordic countries. In this article we take a brief look at some of these aspects.

Sweden

In Sweden most of the real estate transfers between legal entities are done by acquisitions of shares in a limited liability company. The company owns the property and it is the shares of the company that are being transferred. Such an arrangement is advantageous for the parties since acquisitions of unlisted companies are not governed by any specific rules. Moreover, no transfer tax is levied on share transfers. Acquisitions of unlisted companies may, however, be subject to specific provisions set out in the company`s articles of association or in a shareholders' agreement. Furthermore, transfers of real estates are subjected to stamp duty and the acquirer must pay a fee when applying for registration of ownership in the Real Property Register. The transfer tax is 4.25% of the consideration for the real estate or of the tax assessment value of the real estate for the previous year, if higher. To avoid such costs, the real estate transfer is made through the sale of shares of the company holding the real estate.

The deduction relating to the liability to pay the deferred tax in the is negotiated between the parties as part of the calculation of the purchase price mechanism before entering the share purchase agreement, and varies depending on the type of asset(s) owned by the company. The deferred tax is calculated by multiplying the corporate tax by the difference between the agreed property value and the company residual tax value of the properties in the company. For financial years beginning after 31 December 2021, the corporate tax is 20.6 percent. When calculating the deferred tax, the corporate tax value shall be applied which will apply when the deferred tax will be paid.

In 2017 a governmental committee presented a report (SOU 2017:27) with a proposal for a radical reform intended to tax indirect disposals of shares in property holding entities at the same level as disposals of real estate. The suggested reform was widely criticized and has not led to legislation, but some changes have been made to the rules on transfer tax. Although the general tax situation has changed somewhat there is still likely that there will be changes in order to reduce the differences.

In addition, the Swedish Government has implemented an investigation for the Swedish Mapping, Cadastral and Land Registration to execute, and the result are expected to be presented in December 2021. The purpose with the investigation is to investigate whether a general stamp duty should be implemented in Swedish legislation for the acquisition of real estate through cadastral procedure in the same way as for acquisitions through purchase. If there are no prerequisites for introducing a general tax liability, the authority shall instead submit proposals that counteract circumvention of the stamp duty in such acquisitions.

Denmark

Most investments in Danish real estate assets are completed as indirect acquisitions by transfer of the shares in the legal entity owning the property. Through the indirect transfer of the property via a share deal, taxation of capital gains is avoided, as capital gains on the shares held by limited liability companies are generally not subject to Danish taxation. Also, an indirect transfer of a property requires no registration fee as the title to the property is not transferred.

Deferred tax liabilities relating to the property (i.e. based on the difference between the tax book value of the property and the agreed value of the property) are as a main rule included as a liability when the net equity of the company is calculated, ultimately reducing the purchase price. The handling of deferred taxes is part of the commercial negotiations when the property value is agreed on, and often it is agreed that deferred tax liabilities will be included at a percentage between 50% and 100%; however, more recently following the introduction of mark-to-market taxation, it has become more common to include deferred taxes at 100%.

Pursuant to a political agreement announced in October 2020 concerning the funding of a government early-retirement pension scheme, it is expected that mark-to-market taxation of capital gains on real estate owned by companies - and independent of any change of control of the company - will come into force on 1 January 2023. This will eliminate the present possibility whereby taxation of unrealized gains from the sale of real estate can be avoided by transferring properties via a transfer of shares. Mark-to-market taxation of capital gains on real estate will mean that the yearly, increase in the fair market value of a property owned by a company from the beginning of the year till year-end will be taxed, even though the gain (increase) or the loss has not been realized.

The bill has not yet been introduced, so a number of important aspects remain uncertain. This includes (i) procedure for determining value, (ii) how any unrealized capital gains generated prior to the new regime coming into force will be treated, and (iii) to what extent (if at all) the current right to depreciate on certain types of buildings will be maintained. The political introduction of mark-to-market taxation has already had an effect on the commercial negotiations in real estate (company) transactions, as purchasers of real estate companies have become more hesitant to accept booking of the deferred taxes at an amount lower than 100%.

In addition, parties will generally also agree the extent to which deferred tax assets, such as tax losses carried forward, will be included in the closing balance sheet and/or in the calculation of the net deferred taxes. Most commonly, tax assets will be included in a net calculation of deferred taxes, and thus at the same value as is agreed with respect to the deferred tax liabilities. However, it depends on the particular circumstances and the extent to which the purchaser is able to utilize the tax assets in question.

Finland

Most investments in Finnish real estate assets are completed as indirect acquisitions by transfer of the shares in the legal entity owning the property. The most preferred company form is a mutual real estate company (MREC). The other company form owning property is real estate company (REC), but this company form is very seldomly used.

MREC's purpose is to own and manage real estates. Based on its articles of association, the shares entitle the shareholder to manage and occupy a specific part of the building/real estate owned by the MREC i.e. the shares of an MREC are attributable to specific part of the building/real estate and based on their shareholding, the shareholders are entitled to hold and control the respective parts of the building/real estate. The rental income arising from the lease of the real estate accrues directly to the shareholders. The income received by MRECs comprises usually of maintenance and finance charges that the shareholders pay to the MREC. In general MRECs make zero profit for accounting and tax purposes. In practice this is done by adjusting the maintenance and finance charges to correspond to the actual costs of the MREC.

Our experience is that if the shares of a REC are sold, the company form is changed to an MREC after closing.

Latent capital gains relate to situations where the fair market value of the underlying assets owned by a company are higher than the remaining acquisition cost of the assets for tax purposes. The latent gain may have a relevance e.g. in situations where a real estate company is acquired, and the intention is at some point sell the underlying assets owned by the real estate company. The acquisition cost of the shares in the acquired real estate company reflect the fair market value of the assets but this value is not reflected in the value of the underlying real estate at the level of the real estate company for tax purposes. As the fair market value of the assets owned by the company may be higher than the remaining acquisition cost of the assets for tax purposes, the sale of the assets could create taxable capital gains at the level of the company holding the assets. This difference can be regarded as latent capital gain.

In Finland an MREC usually does not sell the assets that it owns. Accordingly, the main rule is that when a real estate is owned by an MREC the acquisition is carried out as a share deal, i.e. the purchaser acquires, and the seller sells the shares in the MREC. Therefore, the potential latent capital gain related to the potential difference between the fair market value of the underlying assets and the remaining acquisition cost of the assets for tax purposes is not realized.

In Finland it is not a standard market practice to take the potential latent capital gains or deferred tax liabilities into account in the valuation of an MREC and therefore it is not discussed in transactions.

Norway

As in the Nordics otherwise, transfers of commercial real estate in Norway are predominantly structured as share deals. Due to the exemption method implemented in 2004, capital gains on shares in limited liability companies owned by resident corporations are generally exempt from taxation. In addition a share purchase does not trigger stamp duty (2.5% of the asset value) as opposed to a direct transfer of the property.

Tax-free reorganizations as mergers and demergers are also generally accepted. Typically, the property is transferred to a separate subsidiary, which is then acquired by the purchaser. Following a Supreme Court judgment in 2014, such dispositions are as the main rule not considered as a tax circumvention even if the reorganization takes place after the disposal is planned or agreed.

Upon preparation of new anti-avoidance regulations in 2019, the Ministry of Finance suggested that this practice should be limited. However, the majority of the Parliament`s Finance Committee considered that the current practice was to remain in place with respect to intra group reorganizations carried out in connection with real estate transactions.

There are no clear political signs that the anti-avoidance rules will be tightened or that ongoing capital gains taxation will be imposed in Norway in the near future. It remains, however, to be seen whether a possible change of government after the election later this year could pave the way for this, possibly inspired by what is taking place in Denmark.

The industry has over the years adapted to the existing tax regime. Deferred tax on the balance sheet of the target company related to the subject property rarely implies a purchase price discount in itself. The basic assumption is that this will not be payable at any point unless the purchaser should choose to divest the property out of the company, which there normally will be no good reasons to do.

However, purchasing the property company means that there will be no step-up of the tax depreciation values as would have been the case if the property was acquired directly. This implies an increased future tax burden for the purchaser as the annual depreciations for tax purposes will be correspondingly lower. According to firm market practice, the purchaser is granted a discount for the net present value of this loss of depreciation, normally calculated to 9-10% (for assets depreciated at a rate of 2% annually) of the difference between the agreed property value and the existing tax depreciation basis.

As land is not subject to tax depreciation, the market value of the plot is also deducted before the tax discount rate is applied. This can lead to considerable negotiations on the land`s share of the total property value if not predetermined.

Residential development companies are an exception. As the subsequent realization of the developed property is a pre-requisite, the tax discount is normally calculated based on the latent capital gains.

Other tax positions of the target, such as tax losses carried forward and gains and losses account, are in practice often compensated for to the extent they represent an actual asset or liability.

DLA Piper in the Nordics

DLA Piper is the only international law firm with a presence throughout the Nordic countries. Our clients benefit from the resources of our global footprint combined with local insight and experience.

Real estate is a core practice our firm, which means that we provide integrated services for all areas within real estate. Our global real estate group is one of the largest in the world.

DLA Piper`s Nordic Real Estate team work together on a regular basis on cross-border mandates from international investors, lenders, developers and managers in every aspect of their real estate activities in the Nordic region.

Contacts

Gustaf Strøm
Partner, Head of Real Estate
Sweden
T +46 70 755 55 07
gustaf.strom@se.dlapiper.com

Erik Björkesson
Partner, Head of Tax
Sweden
T +46 73 518 81 04
erik.bjorkeson@se.dlapiper.com

Emilie Møller
Partner, Real Estate,
Denmark
T +45 51 43 49 49
emilie.moeller@dk.dlapiper.com

Artur Bugsgang
Partner, Tax
Denmark
T +45 21 62 04 63
artur.bugsgang@dk.dlapiper.com

Mikko Larvala
Partner, Head of Real Estate
Finland and Nordics
T +358 40 718 5209
mikko.larvala@fi.dlapiper.com

Antti Paloniemi
Partner, Head of Tax
Finland
T +358 40 586 1051
antti.paloniemi@fi.dlapiper.com

Anders Bergene
Partner, Real Estate
Norway
T +47 91 89 48 01
anders.bergene@dlapiper.com

Jonas Aartun
Partner, Head of Tax
Norway
T +47 95 07 44 47
jonas.aartun@dlapiper.com