RENTCAL
European Rental Housing Framework for the Profitability Calculation of Energetic Ret rofitting Investments

Funded by
The European Union

Legal Framework Conditions for Energy Efficiency Retrofit Investments in the Private Rental Housing Market Sector

(Summary of WP3)

KEY FINDINGS

- The precise and attributed to strictly identified actors formal energy efficiency requirements are (conditionally – see the next point) the most effective measures to induce improvement in the housing stock.
- Requirements without means to comply with them can only be counterproductive: obligation imposed on the landlord to perform energy refurbishment without empowerment of the landlord to conduct the respective works independently of tenants' will can only push-out the most active market players to other industries.
- Successful investments in databases are equally important as investments in the housing stock. Without proper statistical data, the policies developed tentatively can only be assessed ex post – with all risks involved.
- A measure stimulating some sub-sets, to other subsets may have depressant effect due to their different fiscal situation. Whenever a measure is envisaged, it has to be either dedicated to a very narrow tax-payers group, or has to be individually tested for all various tax-payers sub-groups which would be affected.
- The retrofitting activities should not be hampered by administrative purposes and fiscal convenience.
- Tenants' involvement triple mechanism can be based on: (i) a piguovian tax on energy carriers, (ii) right to initiate and participate in refurbishment investment, (iii) right to profit from supporting measures tailored to tenants' profile rather than to landlords' profile.

CROSS-COUNTRY FINDINGS

- The Member States should better inform about refurbishment options and create the measures for educating landlords, tenants and all market actors involved in increase of energy effectiveness of housing stock.
- Due to unreasonable recognition of liabilities resulting from EPC contracts (in local accounting standards) and some formal limits on liabilities, in some countries the ESCO financing becomes inapplicable. Good examples from neighbouring countries do not help as much as could help the guidance from EC or a pan-European accounting standard.

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- The diversity of the EU fiscal systems is one of the most substantive barriers on the way to pan-European policies and solutions. The same diversity gives an opportunity to observe in real life how various fiscal solutions encourage economic entities to enter into ventures aiming at optimization of energy performance of their buildings.
- Simple schemes proved to be more effective than “parametric stimulants” assuming investors to create their own solutions satisfying the conditions meant by policies. KfW programmes for residential buildings (see: KfW) and the LEME list associating programme Polseff are good examples.

COUNTRY SPECIFIC FINDINGS

- Taxation should be non-discriminative – it should not depend on formal aspects (like legal form). Tax measures applied to some tax-payers groups should be proof against ways-around. A valuable lesson can be learned from UK experiences with Stamp Duty Land Tax (SDLT) payable by natural persons. To avoid it some tax-payers were establishing control over the property via shared investments vehicles or via controlled corporate entities. A remedy was to be the Annual Residential Property Tax (ARPT), which later-on was subject of few refinements under new name: the Annual Tax on Enveloped Dwellings (ATED, see ATED).
- Spanish cost sharing experiences are worth popularization as legislative works are going on in some countries where no such legal provisions exist .
- Denmark resigned from property transfer tax. The idea behind is twofold. Firstly, if the property has been used as primary habitat, then its sale should probably be connected with vital financial operation, thus should be exempted from taxation. Secondly, if the premise was a subject of economic professional activity, than the net result on sale will be subject of CIT and no additional taxation is necessary.

POLITICAL IMPLICATIONS

- Too demanding effectiveness targets without ability to collect respective revenues over a market-acceptable payback period require public support for investors.
- Creation of the rental market-related policies and all the instruments to implement such policies should generally be developed with the participation of stakeholders representing all areas: strictly legal (of relevance to the shape of the lease agreements), fiscal, social, engineering, geopolitical, health-related, spatial planning and representatives of both private rental market sides (landlords and tenants).

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- Admitting the cross-financing public support to landlords operating on a free rental housing market, can pull them closer to social housing segment instead of increasing social stratification of the market segments.

INVESTOR'S PERSPECTIVE

- Swift changes in fiscal policies make the effectiveness of them dubious – long term strategies are of much bigger value to the investors.
- Unlike the transaction taxes, the marginal (nowadays) role of property taxation makes much room to find a balance between income taxation and property taxation on the way to find effective stimulants for investors

OTHER STAKEHOLDER PERSPECTIVE

- In order to effectively improve the rental housing stock a huge and efficient segment of service providers is necessary. Parallel to rental law it is therefore necessary to assure the existence of the well-prepared and strong economically segment of respective service providers.
- Weak integration of fiscal law within legal structures developed in other areas (like: accounting, construction, healthcare etc.) may lead to ambiguity and discourage risk-averted investors from energy efficiency undertakings.

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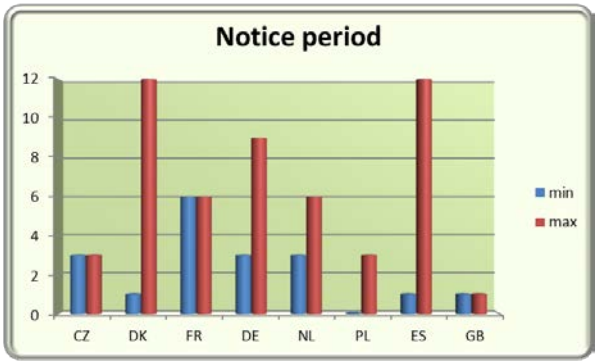
FURTHER READING & SOURCES

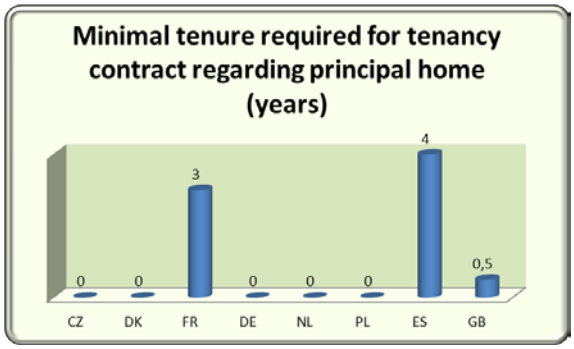
A summarising note[1] by Piotr Kazimierczyk

Profitability of energy retrofits of rented premises is influenced by lots of factors: settlements between landlord and tenant, obligations versus: tax, health, environmental, state and municipal authorities, recurrent exploitation costs, tear and wear costs, financing costs, potential fiscal or direct support opportunities, technical issues influencing maintenance, refurbishment, reconstruction or development options and prices, administrative obligations. Contractual law (civil law), tax law, environmental law, construction law, planning codes, health protection law, energy conservation law apply. Based on comparative analysis of 8 national RentalCal (CZ, DE, DK, ES, FR, NL, PL, UK) legislations, the following observations were derived in order to: (i) exemplify the most material issues, (ii) put them in a wider perspective by bringing back the past changes, showing solutions from other countries and discussing trends, (iii) explore the potential of changes, in particular by invoking valuable experiences from other countries.

Contractual issues

In all RentalCal countries both fixed-term and open-ended contracts are legally possible. Even though in Spain and in UK there are no schemes with indefinite periods, the contractual rule of freedom of contracts makes it possible for landlord and tenant both agreeably willing to conclude such a lease by incorporating a contract clause stating that the contract continues until one or both parties decide to terminate it. Due to common use of principle of freedom of contracts even very short tenancies are possible in all countries but with the restriction of the analysis to principal homes only, the level of assurance changes considerably. While in some countries (CZ, DK, DE, NL, PL) no minimal tenure period is required also in case of principal tenant's home, in France the minimal term for empty dwelling is 3 years (one year for furnished dwelling), as is also in Spain, where additional year is added in case where tenant calls the yearly extension option before the end of the initial (mandatory) 3-years contract period. Compared to UK 6 months this are relatively long periods.





Where tenancy enters a repetitive renovation mode (this is the case for renewable tenancies in all countries as liberty of contracts exists in all of them,

[1] This short and simplistic text is only a brief summary of 649656 — RentalCal — H2020-EE-2014-2015/H2020-EE-2014-3-MarketUptake Deliverables D3.1-D3.3 (available at http://www.rentalcal.eu/RentalCal%20reports). Interested reader is encouraged to reach for full publications.

but is envisaged as standard in France, Germany, Spain and UK) the parameters deciding about the strength of tenants' protection (and landlords patience needs) are twofold: (a) renewal term, (b) premature termination notice term. Shorter of the two decides about possibility to start refurbishment, especially if tenants' consent is necessary. Similarly, in case of time-indefinite contracts the same role plays the termination notice term. The data in the figure on the left are simplified, of course, as notice periods depend on contract types, their duration and contractual agreements, but the Figure give the flavour of conditions which the landlords face in particular countries. It is worth noting that the British AST contract represented in the above figure gives exceptionally favourable conditions to landlords. The short minimal notice periods in case of DK and PL apply only to special categories of contracts practically not utilised in case of primary dwellings.

In all RentalCal countries the initial contractual rent setting is entirely free for negotiations. Nevertheless, the preservation of "fair" amount of initial rents is being sought for. Generally, a tenant, who initially agreed on the rent amount, but then realized that the negotiated rent is far from the prevailing prices of similar dwellings, has the right bring the case to respective court to revise the rent height. In France and Germany limitation of free negotiations are limited by law with regard to the "tight markets".

Rent increases strongly depend on individual clauses written in the tenancy contract (contractual liberty). The contractual ways of indexation or other type rent revision are dependent only on parties will. However, (a) in absence of specific clauses the typical schemes apply, (b) the prevailing market solutions have strong influence on both tenancy contract parties, (c) typically, some tenant-protection rules are generally applicable and are prevailing over contractual clauses. Usually, the contracts for definite period do not allow for rent increases not envisaged at the contract setting. In case of long-term contracts and time-unlimited contracts the indexation mechanism is usually written in the contract and the calculation of rent increases is strictly pre-determined by the indexation mechanism and the underlying index chosen. Also the frequency of rent increases is limited.

Energy efficiency standards and obligations

There are no unique pan-European energy efficiency standards. The policies are also different among countries as far as the required standard is concerned, as well as what regards the time-frames within which the standards are to be achieved. In all countries the responsible for compliance with the minimal standards is the landlord.

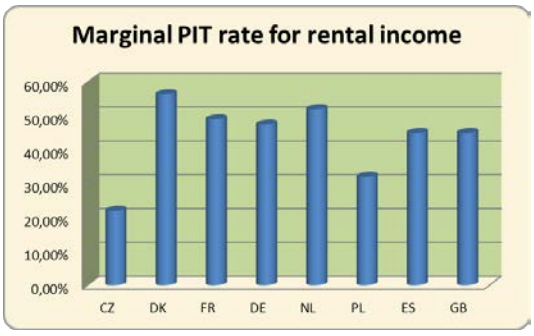
In majority of countries the consent of tenant is necessary for landlord to enter the dwelling for improvement works. The situation is different in case of energy efficiency refurbishment. The objection of tenant against a justified energy refurbishment initiated by landlord is excluded in case of CZ, DE, FR, DE, UK and NL (in the latter case the rent increase after refurbishment is conditioned on the tenant's consent). In Spain the works can be objected if the refurbishment can be postponed till contract end.

Modernisation costs are generally attributed to the landlords. They can seek compensation in rent increase, which, however, has to be either accepted by tenants, or justified in front of the court (if tenant objects the increase amount). In the Czech Republic the rent increase after energy efficiency refurbishment is limited to 10% and the consent of 2/3 of tenants is necessary. Without such consent, the rent in-crease cannot exceed 3.5%. In Denmark "the total economy neutrality" principle applies according to which the landlord is entitled to increase rent by the amount which is saved by tenant due to the savings on energy costs. In France the rent increase after energy refurbishment is limited to 50% of energy costs savings and can be applied at most for 15 years after refurbishment. In Poland the rent increase has to be defended in front of the court if it exceeds the inflation rate. The criteria to justify the increase are not specified and have to be judged case by case based on the statutory concept of "fair" profit, which is also to be individually decided by court based on the current situation and all circumstances involved. In case of Spain it is envisaged and practiced, if agreed by both landlord and tenant, that the tenant directly participates in cost sharing. Based on such expenditures the tenant is then entitled to temporary rent decrease. In Czech Republic and United Kingdom the participation of tenant in refurbishment financing can occur if it is agreed with the landlord.

Due to the general contractual freedom the maintenance costs can be regulated in the tenancy contract accordingly with the parties will. The prevailing market practice in all RentalCal countries is that **the maintenance costs are billed to tenant either as rent or as separate charges**. No situations were identified where any increase of maintenance costs, due to energy efficiency refurbishment, would be the subject of objection from the side of tenants.

Rental income taxation

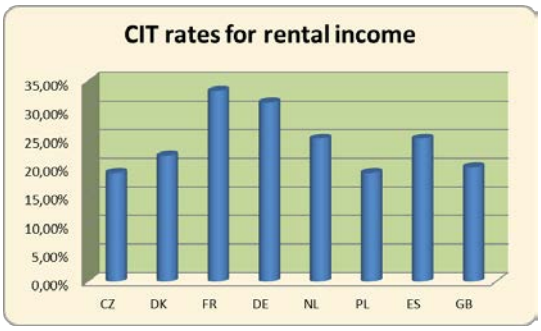
In most countries the **personal** rental income is taxed together with other "earned income" sources, using a general personal income tax (PIT) scale. The scales are usually progressive, with 2 – to 5 levels. Statistics "characterizing the market tax-rate in a best possible way" are not available. The effective tax-rate applicable for each individual landlord is different and depends on many individual factors. Typically, many of those factors are not related to the landlord's rental activity. For this reason any investor has to calculate his/her own applicable tax rate. The marginal tax-rates applicable for personal rental income generated in 2016 in the RentalCal countries are illustrated in the graph at the right[2].



Rental income in the Netherlands is generally not taxed with other earned personal income but as capital gain tax, levied at flat rate 30% of a presumed gain calculated as 4% of net asset value (market value

[2] The graph accommodates many simplifications, like: social security payments/charges/taxes (they are included in marginal rates only if they are not capped), solidarity surcharges (they are included in the above marginal rates if apply to the majority of actors under consideration), church-related surcharges (they are omitted, as typically are voluntarily declared), allowances, regional differences, special taxation schemes and options which can be selected by a tax-payer conducting economic activity as a self-employed entrepreneur.

– debt). Effectively, a landlord is due to pay a kind of "presumed-income-related-capital-gains-property-tax" at a flat rate 1.2% of the property valuation. However, when the rental activities of a professional landlord are seen as the main or substantial activity for the investor/landlord by the Dutch tax authority, the rental income is seen as being derived from work and therefore taxed as earned personal income. As seen in figure 3.2-9, the highest tax rate in the progressive tax system is 52% in the Netherlands on a whole taxable income above € 66 422.



In France there exists a very complicated taxation system allowing private landlords to select from among numerous options. It also depends on geographical localisation and on premise equipment (furnished/unfurnished) and category (dependent on dozens of parameters).

In Poland, the landlords for which renting-out the household dwellings is the subject of economic activity conducted without establishing a share-holding company/corporation can select from among 4 different types of taxation of their rental activity. The marginal rates are 32% (applicable to profit), 19% (idem), 8.5% (applicable to gross income) or a rate (applicable to gross income) set by local tax authorities, respectively.

In England and Wales, the landlord can also balance between personal income taxation based on general PIT scale with marginal rate 45% and trading income taxation depending on the scope of services accompanying the pure flat rental, which is taxed as any market business with flat corporate income tax (CIT) rate 20%.

The **corporate** income tax (CIT) is imposed on company's profits consisting of business/trading income, passive income and capital gains decreased by business expenses. In all RentalCal countries flat CIT rates are adopted. The CIT rates applicable in 2016 are illustrated in the graph at the left. The actual effective tax-rate associated to rental business run by a corporate can strongly depend on the remaining economic activity of the entity. This other activity may be very profitable or may lead to losses. The right to carry-forward-backward the loss of a fiscal year is regulated differently in different countries. In FR, DE, NL, UK the losses can offset profit of the previous year. In CZ, DK, PL, ES the carry-back of losses is not permitted. Loss carry forward is permitted in all 8 countries. The number of years from profit of which one can deduct part (or the whole) of a fiscal loss of a given year ranges from 5 (CZ, PL) through 9 (NL) to infinity (DK, FR, DE, ES, UK), with various restrictions taking form of a cap of income to be used for offsetting the losses. Effective rental-income taxation **rate is strongly business dependent** no matter what is the official CIT rate.

Entities belonging to the "third sector" (NGO, or, more generally NPO) as well as to social services segment most often are **exempted** from income taxation on profits from rental activity. This, however, usually depends on whether the rental contract is in line with the statutory aim of the entity. In some legislations it is legally possible for such entities to conduct auxiliary economic

activities based on purely market-driven principles. If the considered rental activity belongs to this category then it usually is taxed as activity of any other corporate entity (i.e. with CIT rates).

In the Czech Republic rental income of NGOs is subject to general CIT rules (19% tax rate). In France the non-for-profit organizations (NPOs) are exempted from income tax but they have to fill three cumulative conditions: its accessory profit-making activity cannot exceed €60'000 per year and additional restrictions on salaries are to be satisfied. Should the above conditions be violated, then the profits generated within French territory by an NPO are subject to French corporate income tax (CIT) at a standard rate of 33.33% (effective CIT rate from 34.43% to 38% depending on the income amount) with the exception of real estate in-come (rents from leasing of buildings or land) taxed at 24% (real estate gains of NPOs are exempted from taxation in France). In Germany, although NPOs are generally exempted from income taxation, the leasing/letting out of housing properties is considered a business activity which cannot be at all included within the tax-exempted "charitable activity" of an organization. It also does not fit to the category of economic activities (understood as necessary to pursue statutory purposes of the NPO, which are fully tax exempt), whereas as commercial activity they are taxed at the full CIT rate. In Spain NPOs' rental income is taxed at 10% (whereas the standard CIT rate is 25%).

In Germany and Denmark housing cooperatives generally provide housing for members only and are expected not to conduct leasing besides the members, sales or commercial development activities. The statutory housing activity is tax-exempted. In Poland commercial (including rental) activity of housing cooperatives is subject to standard corporate taxation. The exemption from taxes is granted in case of income from housing stock and management related with maintenance of housing stock. Whenever the income from housing stock is used for other purposes than management of housing stock, the exemption from income-tax does not apply. In Czech Republic cooperatives are due the standard corporate tax. In France the cooperatives do not manage private housing stock. The remaining RentalCal countries (ES, NL, UK) apply standard corporate tax rate to income of housing cooperatives with the remark, that in Spain usually cooperatives are traditionally used not for management of common (cooperative) housing stock, but for its development – after the construction works are finished the premises are separated to particular owners and the cooperative is being dissolved.

Capital gains taxation of real estate sales

Generally, capital gains are included in taxable income base and taxed under the standard income tax rate[3]. This applies to both individual investors and corporates. The taxable base is the difference between the sale price and the amortized acquisition costs (i.e. the book value of the premise) decreased by all deductible sale transaction costs which are not otherwise independently recognised in the profit and loss account.

[3] It is to be reminded here, that in the Netherlands the rental income of private individuals is often not subject of PIT, but is taxed under Box3 (capital gains).

In case of individual persons, taxation of profit from selling their property typically depends on three issues: (i) whether the property and the transaction can be considered as part of economic activity of the seller, (ii) time elapsed from the acquisition of the property, (iii) allocation of profits from the sale. Some countries (DE, FR, PL) make exceptions for private individuals who sell the property not serving their economic activity. Such sales are exempted from taxation. Additional requirements have to be fulfilled.

In UK capital gains are taxed separately from trading income and from several baskets of non-trading income, though they form a part of company's taxable profits. While the main CIT rate is 20% (see section 3.1) a 28% rate applies to gains that arise on disposal of UK residential property where the gain is Annual Tax on Enveloped Dwellings (ATED-related.

Property and transaction taxation

In each of 8 RentalCal countries the property tax exists in a certain form, though these forms are unique in each of the countries. In each of the countries the tax-payer is the owner. The tax amount depends on the property valuation for this tax purposes. In some countries (CZ, PL) it is based on land area and property usable area which are then multi-plied by locally, annually determined multipliers established by local authorities under national supervision and within national rules. Approaches taking into account more factors (than area and municipality profile) determining the rental value are developed in other countries. The schemes are both locally dependent and multidimensional (with the aim to closely follow the market value).

Property transfer tax

Denmark resigned from property transfer tax. The idea behind is twofold. Firstly, if the property has been used as primary habitat, then its sale should probably be connected with vital financial operation, thus should be exempted from taxation. Secondly, if the premise was a subject of economic professional activity, than the net result on sale will be subject of CIT and no additional taxation is necessary. Other national legislators did not follow such line. The rates of property transfer tax range from 0% (in UK for transactions up to £ 125'000) to 15% (in UK for purchase of a property worth above £ 2'000'000 by a corporate). In UK and in PL the tax is classified as stamp duty. In UK the scale is progressive, while in Poland digressive. Flat rates are applicable in 2 countries (NL – 2% and CZ – 4%). In France, on top of property transfer tax (called Register tax) additional Acquisition tax is levied. They may sum up to almost 8% of acquisition price. The property transfer tax is payable by the party acquiring the property.

Other property related fees and taxes

Among other types of fiscal burden related with the property ownership the inheritance tax is to be mentioned as material in 3 countries (PL, ES, UK). In Poland the CLAT (Civil Law Activity Tax; 2% of transaction value) is payable by seller, who is a private person, not a VAT payer and acquired the property not earlier, than 5 years before the sale. In Spain, the tax on the urban land value increases, known as The *Plusvalia* Tax, reaching up to 30% of the land value increase, is charged by the town

hall on properties when they are sold and calculated on the basis of cadastral value of property and the number of years that have passed since the property was acquired by the seller. The Building, Installations and Works Tax (amounting up to 4% of investment) can be considered as another kind of property tax on the marginal property being created. Spain also levies Net Wealth Tax at a rate established individually by each of autonomous regions - the rate ranges from 0.2% to 2.5% of the value of the property. Wealth tax is not levied in Madrid. In United Kingdom Annual Tax on Enveloped Dwellings (ATED) was levied on NNP-owners (Non-Natural Persons) of UK residences valued over a certain threshold (enveloped dwellings). The threshold since 1 April 2016 is GBP 0.5 M. The amount of tax charged is based on a banding system concerning the market value at certain dates.

Deductibles, depreciation rules and tax breaks

General practices are similar in all RentalCal countries: (i) maintenance (repairs, replacements, restoration of former value) expenses are considered as tax-deductible costs (opex), (ii) investments leading to improvements (including those increasing energy efficiency), if their value is considerable (exceeding some threshold) are recognized as increasing balance-sheet value of the property and are not subject to immediate tax deductibility, but can be subject to amortization which is tax-deductible over the entire depreciation period (capex). The ambiguity arises where both restoration and improvements are introduced: is then the expenditure replacement (maintenance) or improvement related. It seems that only in few countries (CZ, FR) formal legal definitions discriminating these issues exist and are uniformly employed in both accounting, engineering and taxation laws. In countries, where such definitions are not existent (NL, PL) or apply to taxation system only (DE, DK) or to maintenance concept only (UK) the situation often requires individual analysis and may not be straightforward unless a certain precise allowance scheme is applicable.

Indirect taxes

Accordingly with VAT Directive Art. 168 *"the taxable person shall be entitled (…) to deduct the VAT due (...) in respect of supplies to him (…) from the VAT which he is liable to pay"*. If the VAT due is smaller than the VAT paid, accord to Art. 183: "*the Member States may, (...), either make a refund or carry the excess forward to the following period."* Based on Art. 135(1) (l), the leasing or letting of immovable property is generally exempted from VAT in EU. According to Art. 173 *"In the case of goods or services used by a taxable person both for transactions in respect of which VAT is deductible (...), and for transactions in respect of which VAT is not deductible, only such proportion of the VAT as is attributable to the former transactions shall be deductible."* Thus, the part of VAT paid with regard to retrofit investment which is attributable to rental activity (VAT exempted), is **NOT VAT-deductible**. However, depending on the ways of: (i) attributing parts of VAT paid to other (not VAT exempted) activities (defined in Art. 174 as ratio of revenues from different activities), (ii) of assigning parts of investment expenditures to the part of a building used for rental activity (typically defined by ratio of usable area used for different activities), in individual cases **part of VAT payed may be VAT-deductible**. This strongly depends on the situation and therefore has to be analysed individually.