

THE PROJECT FINANCE MODEL IN THE SUPPLY OF RESIDENTIAL AND COMMERCIAL PREMISES

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Abstract

A supply of dwellings greater than the demand, a reduction in the availability of housing loans and increased credit risk, caused, inter alia, by the financial crisis: these are the basic features of today's residential property and commercial premises markets in Croatia today. Built but unsold housing units have exposed private investors, who have organised the supply of units within the balance sheet of their firms, to significant risk of underinvestment. The materialisation of this risk is most manifested in the impossibility of funding the core business because of loans that they have agreed on for the construction of dwelling units meant for sale on the market. The paper then proposes a model that, if it were applied, could insure investors to a greater extent against the risk of underinvestment.

The supply of dwelling units with protected rentals by the local public sector organised in the traditional manner, i.e. according to a model in which the local public sector figures in the role of investor, distributes the burden of development costs onto the future generations as well. However, practice has shown that traditional models inequitably expose future generations to the risk of a reduction in the quality of this kind of public service. From this point of view the proposed model transfers to the future generation not only the costs but also the obligations to secure equal qualities of public service in such a way that the private investor long-term assumes the risk of the availability of public building. The problem in this kind of organisation of the supply of a public service is double taxation via VAT, changes in the law concerning which are accordingly proposed.

Key words: project financing, housing construction

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1 Introduction

A considerable number of different models for the supply of dwellings and commercial premises exists in the Croatian market. Two fundamental models stand out: the sale of commercial premises and dwellings, and rental with a non-returnable rent. The supply of built dwellings has not met with corresponding demand for a number of reasons, one of the most important of which is the reduced supply of housing loans from banks, as a result of enhanced credit risks. In such market conditions, investors who have financed the costs of developing structures by borrowing have got into a situation in which loans have matured and yet the built units have not been able to be sold to either natural or legal entities above all because of a reduction in the supply of housing loans. This article will present a model in the framework of which loans for the construction of buildings would be refinanced over the long term, and the buildings would be supplied to a new market, characterised by long-term lease and transfer of ownership of the rented structure on maturity of the long-term lease without further charge.¹ A similar model exists in developed countries, most of all in the segment in which dwellings are supplied by the local public sector. There have been attempts to make this model viable in this country; however, the application of existing tax regulations to the model makes it unjustifiable for the reason of the double taxation attracted by some transactions. For this reason the article proposes modifications to some of the regulations the objective being that all the agents in the project should have an interest and reap greater benefits than in the traditional models of sale and rental.

2 The fundamental features of existing models of the supply of business and housing premises and the techniques of project financing

A number of years in which long-term loans were available to legal and above all to natural persons led to a situation in which demand for dwellings and commercial premises was greater than the supply. Such a supply-demand mismatch led to a rise in the sales price of new and already existing residential and commercial property and generated a whole series of new individual investors who identified a chance for earnings in the sale of newly built residential and commercial premises. The supply was financed with relatively short-term loans (most often up to three years), the maturity period of which should have been sufficient for development and sale. An important characteristic of this model of financing is that the share of the loan in the total sources of funding was very high. On the other hand, demand for this kind of newly built premises, depending on whether the purchase was private or corporate, was financed with long-term loans, with maturity periods of ten to thirty years. The most frequently employed model for the supply of new commercial or residential property is shown in Diagram 1.

¹ Because of the difficulties in the sale of products, in the 1930s in the USA various forms of leasing and renting real estate and later of moveables began. Such transactions appeared in the UK in the 1950s, and in the 1960s in other countries of Europe (Vukičević, 2000).

Diagram 1: Existing model for financing the construction and sale of residential and commercial property

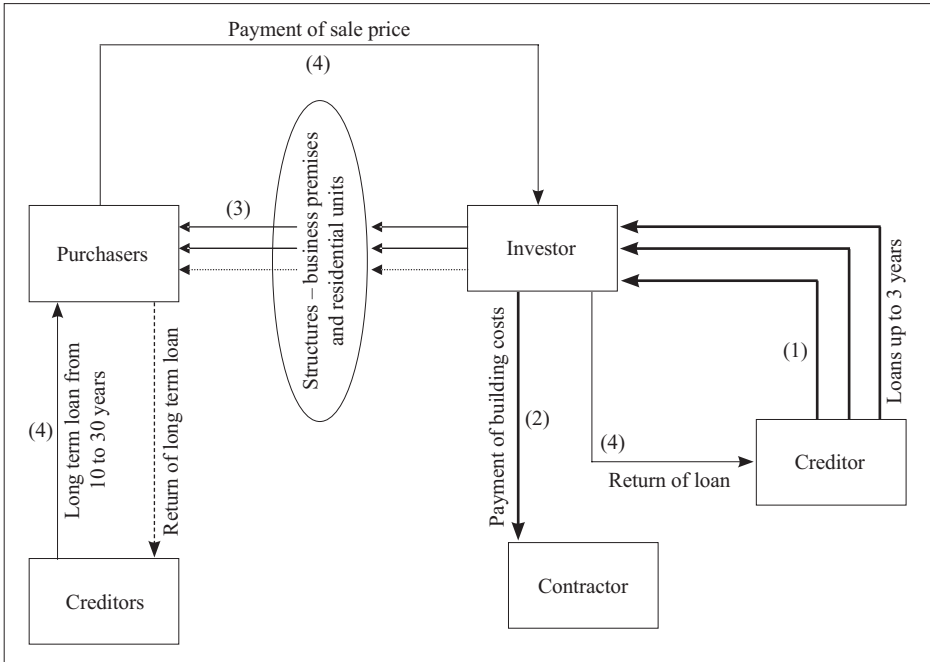


Diagram 1 shows clearly that the investor takes on short term loans (1) so as to pay from this credit most of the costs of building to the contractor (2). When the buildings are completed, the investors sell them to corporates or individuals (3) who mostly pay for the purchase with long-term loans (4). Creditors and investors call this manner of financing project financing. However, the use of the term project financing with such models is not in line with the theory and world practice in project financing (Esty, 2004; Gatti, 2008; Finnerty, 1996; Nevitt and Fabozzi, 2000; Levy, 1996; Merna and Njiru, 2002; Hoffman, 2008; Built-Siering and Dewulf, 2006; Yescombe, 2007). Accordingly it is necessary to differentiate financing projects (balance sheet financing) and project financing (off-balance sheet financing). In the model described in Diagram 1, which represents the financing of a project, the loan is granted to the investor's parent firm. In nature, every new construction project is on the one hand stated in the assets of the investor, and on the other hand, the source of financing of this project in the investor's liabilities. Several projects in the assets most often mean several loans in the liabilities. This is in contrast to the theory of project financing, since in the use of the technique of project financing the parent firm of the investor does not take out a loan, rather the special purpose entity² that lasts for a defined period.

² SPE (special purpose entity) or SPV (special purpose vehicle).

The second contradiction to the theory of project financing is that the sequenced projects in the balance of the core business firm of the investor have been financed with loans of relatively short maturities, as against the loans that are used in the financing of special purpose entities that most often have a maturity in excess of ten years.

Then, the basic security instruments of these loans have been the land and the built structure the construction of which was being financed, but as additional “hard” security instruments a lien is placed on some other piece of real estate owned by the investor. In the application of the project financing technique the basic collateral is the structure the construction of which is being financed. This object is owned by the SPE, and if the parent firm gives an additional guarantee, this is a corporate guarantee to cover any deficit in the cash flow of the SPE without the creditor having any right to recover money from the parent company of the investor.

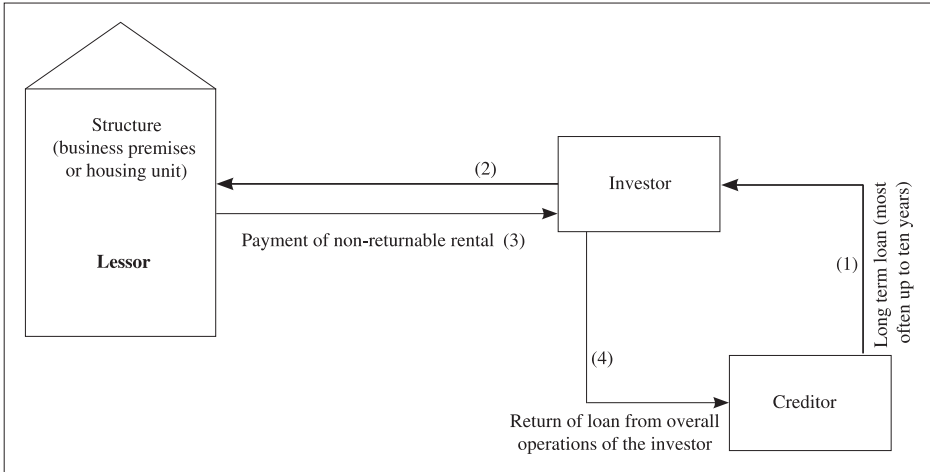
One more situation of the described model does not support the use of the term project financing; the creditor, taking standard insurance instruments from the investor, i.e. the parent company of the firm that is here also an investor, has the right to collect from the whole cash flow of the investor. That is, the insurance of the parent company of the investor from what is called contamination risk³ (Gatti, 2008) is one of the basic motivations for the application of the technique of project financing in the framework of which the new project is financed via a SPE. Accordingly, from what has been said, it is clear that the model described in Diagram 1, which is the model most employed in practice in Croatia, cannot be termed a model in which the technique of project financing is used. In order to reduce the risk of the occurrence of financial difficulties, the investor has to build and sell all the structures by the latest down to the date of the maturity of the loan used to finance the construction, i.e. by three years at the latest.

When an investor builds commercial or residential property not intending to sell but to let it on long leases, then the model is somewhat different, and is organised as in Diagram 2.

By negotiating a longer maturity for the loan (1) from which the construction of the building (2) is financed, the investor reduces the risk of the occurrence of financial adversities. This loan is repaid (4) from the revenue obtained from leasing or letting the structure (3), and should this revenue be insufficient to service the matured annuity, the difference will be made up from the other revenue of the investor. In this case too it is not a matter of employing the project financing technique, mainly for the reason that, most often, in this case too, it is the parent company of the investor that is financed, and the duration of the legal entity that takes on the loan and lets out the structures does not have a limited period, which is the case with SPEs. This model of leasing is determined by one more essential factor, which is that in the event of the rent being broken off by either lessor or lessee, the lessee has no chance of reimbursement of the total lease fees paid from the new lessor.

³ When an investor in its assets has two projects one of which works with a surplus and the other with a deficit, then the deficit of one project contaminates (makes draughts on) the surplus of the other. The contamination risk then is the likelihood that the poor performance of one project will jeopardise the operations of another and the whole of the remaining assets of the investor.

Diagram 2: Existing model for financing structures to be leased



3 Advantages and drawbacks of existing (traditional) models

These models for property development and letting that, for the sake of more effective distinction from the newly proposed model, can be called traditional models have the following advantages.

- The model is easy to understand.
- In the case of a rise in demand for dwellings and business premises the model can be put into practice quite rapidly.
- Corporate banking loans for the development of buildings usually have short maturities. The loans used to finance development costs mature in a period of two to three years. For smallish structures this period is enough for the conclusion of the construction works and the implementation of the sale procedure. Since these loans mature a single time at maturity and since during the time they are being used they attract only intercalary interest, this form of financing gives high yields for the creditor. Because of the short maturity, it can be used several times in a short period. Because of the relatively high ratio between sale price and cost price in conditions of the availability of long-term loans from which the purchase is financed, these loans are relatively well secured by a favourable relation between the market price of the collateral and the amount of the loan.
- When the development is finished, the creditor disperses the credit risk among the individual purchases of dwellings and business premises the development of which is financed from one, for example, three year loan.
- The risk of repayment of a three year loan for the construction of the structure is controlled by the long-term housing loans.
- In conditions in which the market is on the rise the government can collect large sums of value added and property transfer tax.

Notwithstanding all these advantages, these models also have some essential drawbacks or disadvantages that come out precisely during a time in which the market for long-term loans stagnates, which leads greatly to a reduction in demand for commercial premises and housing. The most important drawbacks of these models are as follows.

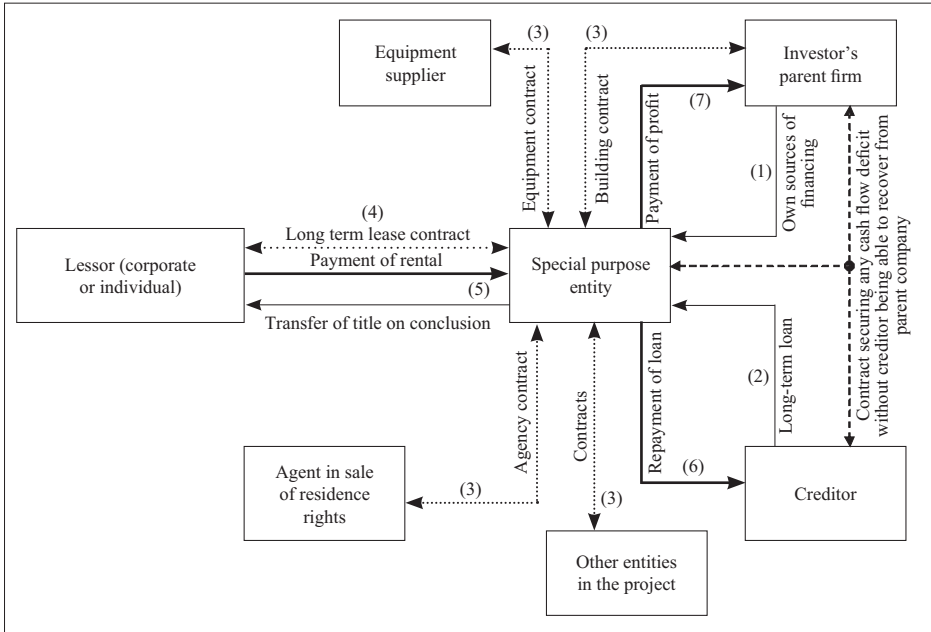
- Difficult development loan servicing in conditions in which the market for long-term housing loans to natural persons and corporate investment loans is stagnant. In such conditions, loan repayments have to be secured by foreclosures or other measures.
- In the case of financial hardships on the part of users of long-term loans for the purchase of buildings, the collection procedure via foreclosure and sale is lengthy.
- In the model of letting out the structure, the tenants or lessees do not have any chance of being reimbursed for the rentals paid.
- In the dwelling rental model the investor has additional costs because the VAT incurred during the course of the investment cannot be reimbursed in its entirety.
- On the conclusion of the sale, in a relatively short period of time, the purchaser loses all rights to make claims upon the vendor if there should be defects in the building.
- In the case in which commercial premises are bought from a corporation, the debt from which the purchase is financed is shown in the balance sheet. In the case in which a corporation buys commercial premises, it finances the purchase from a long-term investment loan. This long-term loan is stated in the balance sheet of the corporation. It increases the risk of under-investment, which means that the corporation has a reduced credit capacity and reduced ability to borrow for any other business possible business undertakings.
- The complex and lengthy procedure of the foreclosure process for the collection of the debt. In the event of the loan being permanently uncollectible, the creditor, having pronounced the loan due, collects via foreclosing on the collateral. This procedure is in practice long-lasting, makes creditors unpopular, and inflicts material damage on the user of the loan.
- In the model in which buildings are let, the rental is often too small to cover the due long-term debt service payments and the shortfall has to be made from the remaining cash flow of the investor.
- In conditions in which the economy is contracting, the government loses large sums of revenue from value added tax and real estate transfer tax.

4 The build, lease and transfer model

Combining the advantages and reckoning with the drawbacks of the two previously described models for the supply of housing and commercial premises and, of course, in conjunction with modifications in the tax laws, it is possible to put forward a new model that is based on long-term lease and transfer of title on the conclusion of the lease period.

This is a model in which the investor builds and finances the development of the structures and makes them available to individuals and corporations on long-term leases. The organisation of the build, lease and transfer model (BLT) is shown in Diagram 3.

Diagram 3: The build, lease and transfer model



The parent firm of the investor organises the development and the financing of the project for the construction of buildings via a SPE (Finnerty, 1996) (1). This company takes on a debt covering most of the total costs of development with financial institutions (2). The SPE enters into contracts necessary for the performance of the project with other agents in the project (3) and makes a long-term lease arrangement with the lessee (4). From the rentals received the SPE pays for operational costs, financing costs (6) and profit to the owner (7). With this kind of organisation it is made sure that the debt for the project is not recorded in the balance sheet of the parent firm but in the balance sheet of the SPE, which reduces the risk of parent firm under-investment (Esty, 2003; 2004). The risk of under-investment means the risk that the parent firm will be unable to take out more loans for new business opportunities or projects because it is already in debt with to the extent of the loan for the existing project. This is the situation when the first builds structures according to the traditional model. Since in the BLT model the debt is transferred to the SPE, of which there can be several, depending on the number of projects, the balance sheet of the parent company has no registered debt. The parent firm makes its earnings over a long period of time, and if it is also the contactor, it makes sure that its capacities are fully engaged. Since the value of the equity of the parent firm in the SPE partially

depends on the real collection of future earnings (collected profit made by the SPE), the parent company can always sell its equity in the secondary market and in this way can in a short period of time collect the current value of future earnings.

Depending on numerous factors⁴, the parent firm can contract with the creditor concerning reimbursement of the monetary deficit in the SPE. Since the creditor will estimate the credit risk according to its estimate of the cash flows that are generated during the exploitation of the SPE assets (residential and commercial premises), i.e. the likelihood of creating a sufficient volume of flows from the contractual rental, the parent firm in this contract binds itself that if the SPE does not generate a sufficient volume of inflows, it will reimburse the deficit produced. This guarantee does not give the right of reimbursement to the parent firm from the SPE without the additional consent of the creditor. The parent company does not guarantee for the total value of the loans, but only for the SPE deficit produced.

Since the principal in the project is the SPE, this legal entity goes on to enter into contracts about the development, the insurance of the structure with the insurance company and perhaps about its equipping if it estimates that the structure can be better supplied to the market partially fitted (for example, with kitchen, bathroom, built in wardrobes and so on). Further, an important factor in the model is a contact with a real estate agent in the sale of residence rights. For the lessee enters into a contract with the SPE to purchase the residence right. In this contract, the lessee acquires the right to use the structure for the time that it duly pays the rental. However, should it happen that the lessee is no longer able to pay the rental or decides wilfully to halt the payment of the rental, it acquires the right to sell the acquired residence right on the market and through this sale to get back a part or the whole of the rentals paid to that date. The new lessee evaluates the value that he is prepared to pay to acquire the right to reside and continue the payment of the rentals until they mature and in this way to acquire the right of transfer of ownership of the property without any fee, in concert with the payment of the real property transfer tax.

As compared to the investor in the traditional model of constructing business and residential premises that make their profit by the act of selling the structure, in the BLT model the investor realises its profit in the period in which the project lasts (for example, 15 years). However, in the BLT model too it is possible to collect the profit even before the maturity of the project, but in this case this is achieved by the sale of the equity in the SPE on the secondary market.

5 Advantages and disadvantages of the build, lease and transfer model

As compared with the existing models of building structures with the aim of selling or with the aim of letting/leasing to third persons, the BLT model has the following advantages.

- Greater mobility of the workforce (i.e. lessees/renters) on the labour market is enabled.

⁴ Structure of sources of financing of the SPE, the vigour of demand for housing units, the number of preliminary lease contracts made, the amount of the rental, location of the structures and so on.

- Investors can trade their equity in the SPE thus creating a secondary market.
- Lessees can sell their residential rights and depending on the price recoup the amounts of rental paid thus creating a new market in residential rights.
- If the lessee is a legal entity from an administrative activity⁵, the rental is an entirely tax deductible expenditure, which means that there are significant tax savings.
- No debt is recorded in the balance sheet of the lessee.
- The VAT contained in the sale price of the structure is spread out over the number of instalments of the lease.
- The base for the real estate transfer price contained in the calculation of the cost price is also spread out over the number of instalments of the lease.
- The structure becomes the property of the lessee without any fee (apart from the liability of paying real estate transfer tax) on the payment of the last rental.
- The payment of real estate transfer tax is postponed during the time of the contracted lease. This tax is paid with the last instalment of the lease.
- The condominiumisation of the residential units can be agreed upon as instrument of credit security for the benefit of the creditor.
- Investors ensure a long period for making their profit.
- Credit institutions, making use of economies of scale, incur smaller unit costs of preparation and processing loan applications since in this model one loan only is given, while in the traditional model numbers of loans are made, depending on the number of housing units credited.
- The amount of the rental⁶ does not differ essential from the annuity in the traditional model and is sufficient to cover the operational costs of the SPE, the due instalments of the loan and the profit that is paid to the parent company of the investor (see Appendix 1).
- The creditor disperses the credit risk via the more frequent and simpler changes of lessee as compared to changes of owner in the traditional model of the building and sale of structures.
- Should it be impossible to lease individual condominiumised housing units for a long period of time, the creditor retains the possibility of foreclosing and selling by activating the contractual security instrument. As compared with the traditional model, the creditor has equally solid collateral.
- It is to be expected that if the rental cannot be paid, the residential or business building, with proper lease agreements, can be more swiftly and simply vacated of people and things than is the case in which the purchaser of the structure is credited (the traditional model).

⁵ This primarily applies to service activities, such as insurance and banking, legal, architectural, IT, advisory, commercial and catering and so on activities that are carried out in business premise of this kind (flat and commercial space).

⁶ The amount of the rental depends on the distribution of the risks among those taking part in the project, or the risk assumed by the SPE.

- Irrespective of the state of the market (contraction or expansion) the state always has stable tax revenue.

Table 1: Comparison of the traditional and the BLT model

Criterion	Traditional	BLT
Project preparation	Simple.	More complex.
Duration	Short term in the case of sale. Unlimited in the case of leasing.	Long-term, limited.
Providing loans for building	From total assets and cash flow of investor.	From assets and cash flow of the SPE and with limits from the cash flow of the parent firm.
Risk of under-investment	Great for investor. Great for purchaser.	Minimal for investor. Minimal for purchaser.
Contamination risk	Large for investor.	Minimal for investor.
Credit worthiness of parent firm on market	Adverse effect of the debt on credit worthiness of investor.	Positive effect on parent company credit worthiness.
Structure of finance sources	High leverage in parent firm of investor.	High leverage in SPE.
Vigour of demand	Related to condition of long-term credits market and credit capacity of purchaser.	Conditioned by ability to pay rental.
Vigour of supply	Related to condition on the medium-term investment loans market.	Related to condition on the long-term investment loans market.
Supervision of investor operations	Complex and expensive because of the numerous transactions and confusion of cash flows.	Simpler and cheaper because there is an unambiguous cash flow and a small number of transactions.

Disadvantages of the BLT model are as follows.

- The model is more complex in the preparation phase since it is necessary to provide preliminary contracts about the lease of the structure before the credit contract, because the credit risk is estimated on the basis of the confirmed demand for the leasing of the structure.
- The uncertainty of future regulations related to the payment of real estate transfer tax in the transfer of ownership of a BLT structure to the last lessee exposes the lessee to political risk.
- Since in the financing of legal entities (of the SPE) the maturity periods of the loan are not as long as in the financing of individuals for the purchase of dwellings, the rental could be somewhat higher than the loan repayment instalments from which the purchase of such a structure by an individual might be financed. On the other hand the possibility of financing BLT with credit for 15 years and more enables corporates a lower rental than would be the case with an instalment from an inves-

ment loan from which it would finance the purchase according to the traditional model (usually up to 10 years).

- An inadequately prepared and financed SPE can bring about reduced transparency in the operations of the parent company and an untruthful presentation of the total risks of the operations of the consolidated parent company.

Comparing these advantages and drawbacks of the existing or traditional model for supplying residential and business premises with the advantages and disadvantages of the build, lease and transfer model, Table 1 can be drawn up.

6 Application of the model

The model described in Diagram 3 can be applied both to structures that are still to be built and to already built structures that cannot be sold before the maturation of the loan for the finance of the building of the structure.

6.1 Application of the build, lease and transfer model to structures already built

Since on the market there is already a large number of both residential and business premises, the sale of which, primarily the intended sale of built structures, could be reorganised in such a way that the structures are leased long-term including the right of the last lessor to be transferred the title to the structure that has been paid for by rentals on payment only of the last rental, with the obligation of paying real estate transfer tax. If, on the one hand, the existing loan for the building was refinanced with a longer maturation period (for example of 15 years and longer) and offer the market the possibility of entering into a long-term lease agreement with transfer of title to the structure when the long-term lease was mature, because of the surplus of advantages to disadvantages, it is possible to expect greater demand for supply shaped in this way than for the traditional supply of buildings. Since the rental contains the instalments on a long-term loan augmented by profit, it follows that the founder of the investor (the SPE) will reap the benefit over a longer period. If the founder of the investor cannot wait for the loan to mature and if the secondary market for equity of companies formed in this way becomes viable, the equity can be sold even before the loan matures and thus the current value of future profits can be collected. Naturally, which discount rate will be used depends on current market conditions.

For structures that are primarily intended to be sold on the market to be able to be leased, they must have their purpose changed. However, the actual change of purpose settles the possibility of leasing instead of selling; but it is also necessary to change the VAT Law in such a way as recommended here since in the lease, all the investment costs would be stated, and with change of purpose and reorganisation of the existing project, organised according to traditional models, it would be necessary also to contractually provide for the transfer of ownership of the structure to the lessee without any charge for the charge is actually paid through the rentals. A constraint in the application of the BLT model to buildings already built but unsold also lies in the implementation of splitting the investment off from the balance sheet of the parent company. Here it is necessary addi-

onally to evaluate whether the position of the creditor has been diminished as compared to the existing credit risk.

6.2 Application of the build, lease and transfer model in the supply of public dwellings with protected rentals

This model can also be employed in the framework of the public sector in the formation of supply of council flats or social flats with protected rentals. The local public sector lays down the standard of supply of this public service, i.e. the supply of dwellings and business premises, and invites a bid for the choice of investor capable of delivering this standard with the least possible rental. The selected investor will build the structures (mainly dwellings), finance the building and maintain the buildings to as to keep them in available condition for a contractual number of years. The local public sector pays the rental to the SPE and collects rental from the sub-lessees who have obtained the right for housing on the basis of a set list of priorities. In this way the local public sector takes on the demand risk. This further has a positive effect on a large number of interested investors from the private sector, creating good conditions of competition. The amount of the sub-rental (the rental that the local public sector charges the end users) is determined by the local public sector itself according to social criteria and standards. On the conclusion of the lease contract signed between the SPE and the local public sector, the public sector assumes title of the property without any further, only on payment of the last instalment of the rental.

As a result of this kind of relationship, the credit risk is evaluated on the basis of the ability of the local government unit to pay, and not on the ability of the end user to pay. This model is favourable for the local public sector, since the built structure is not recorded in its balance sheet.⁷ Record of the asset is carried out only when the contractual lease period is concluded, when the SPE transfers title of the property to the unit of local government. Since cities and municipalities have at their command considerable resources from the sale of dwellings that were socially owned, the purpose of which is solely for the building of new dwellings, statutory regulations should enable to be earmarked for the payment of rentals laid down in this way. The basic reason is that when the lease is concluded, the title of the structure is assumed by the local unit. The benefit for the local government unit is also that it provides an appropriate standard and quality of structure for present and future generations, since the investor has taken on the risk of make sure that the structure is kept available, i.e. maintained. From this point of view, the local unit retains the right to pay the rental only if the structures are maintained according to standards set and agreed on in advance. With the employment of the BLT model, the existing problem with the traditional model in which the burden of payment (of a long-term loan for example) is transferred to future generations, while the contractual quality of the public building, and hence the public service that is delivered through the vehicle of the public building, is enjoyed only by the present generations.

Furthermore, the contracting entity of the local public sector starts paying for the service only with the act of putting the structure into use, i.e. into transactions, which is not

⁷ Assets not recorded in assets, debt not recorded in liabilities.

the case with the traditional model, in which the sale price is paid gradually until the object is put to use. Unlike the traditional model, in the BLT model, the VAT contained in the sales price of the public building is distributed over the contractual number of rentals in the future. However, one should pay attention that there are models in use today, the models of public-private partnership, in the framework of which the public partner pays the rental to the private for keeping the public buildings, for example, sports halls and schools, in a usable condition for a longer number of years at the end of which the private partner has contractually bound itself to restore the public building to the public partner without any charge. The VAT is contained in the rental but according to the existing tax regulations, the transfer of title of public building to a public partner when the contractual period is concluded is subject to VAT. According to existing tax regulations the public partner is exposed to the risk of double value added taxation⁸ (once in the rental and the second time during transfer of title to the public building that it has built for this purpose).

6.3 Transfer of the build, lease and transfer model in the supply of commercial dwellings

When the model is applied to the commercial delivery of residential and business premises, unlike the supply of dwellings in the public sector, here it is necessary above all to estimate the volume of demand for leasing from corporates and individuals. From this point of view, if the leasing market has not yet developed, then preliminary contracts concerning the leasing of the structures after their completion and release to use have to be secured. To increase the likelihood of leasing, the investor can engaged agents who will locate demand. These preliminary agreements are essential since the creditor will evaluate the risk primarily on the basis of an estimate of the volume of revenue from leasing the structure, and secondarily only on the basis of the credit worthiness of the parent firm of the investor. The parent firm of the investor has to ensure its own sources of financing of the project and be capable of covering any possible deficit in the cash flow that is generated in the SPE during the period of the exploitation of the project.⁹

7 Roles, benefits and basic risks of entities in the project

Every entity in the project has its own role via which it acquires its own benefits from the association. It takes on certain risks depending on the role it has. It is assumed that the project will be joined by entities that are able to manage the risks taken on with the lowest price. This is a very important assumption since via the SPE the total risks of the project are dispersed to all the entities in the project. The greater the number of entities in the project, the greater the degree of risk dispersion.

⁸ Although the LGU is not in the VAT system, the private partner invoices with VAT. In this sense the LGU pays a total amount of the bill, but has no right to deduction of advance payment of taxation.

⁹ For example, the parent firm can as an emergency measure rent flats that have not been rented out and later collect the emergency payment of the rent from the new lessor, either partially or in its entirety.

7.1 The parent firm of the investor

In the traditional model of building the parent firm is the investor, which is also the owner of the structure until it is sold and the user of the credit. Accordingly, the debt is recorded in the liabilities in the parent company's balance sheet, while the built structure is recorded in the assets. By implementing such a model, the parent company is exposed to numerous risks, most of all the risk of under-investment. On the other hand, if the necessary sale does not happen by the time the credit for the building has matured, then the creditor will foreclose on the entire assets of the firm, i.e. from the cash flow that is generated by the overall operations of the parent firm. In the case of relatively large building projects, as compared to the total existing assets, the proportion of the new debt in the total sources of finance of the firm can be interpreted as excessive which, further, can affect the reduction of the value of its shares on the market. In this sense, by getting into a new and relatively large building project it can reduce its credit worthiness and hence the value of the equity of the shareholders of the parent firm.

When the BLT model is used, the parent firm sets up a new company, the SPE, special purpose entity, the objective of which is just to build the structure, to take on debt to cover most of the costs of construction and then to rent the structures on the market. From the rentals collected the firm will cover the long-term debt servicing obligations due and also pay out profit to the parent company. In this kind of organisation of supply of structures, the parent company protects itself from the risk of underinvestment because the new debt is not recorded in its balance sheet, but only in the balance sheet of the SPE, which means there is no reduction in the credit worthiness of the parent firm. With this kind of organisation the parent firm provides for long-term stable revenues, and also, with the development of the secondary market for equity in the SPE, enables the sale of equity at the then ruling market price. Since the parent company enters into a contract to make good any cash flow deficit with the creditor and the SPE, the creditor has to make sure that the parent firm has appropriate credit worthiness according to which it will evaluate its ability pay according to that contract. In the financial reports of the parent for, this kind of contract is recorded off-balance sheet. As well as this, the parent firm has to be capable of providing reserve sources of finance if budget and construction time risk materialises.

7.2 Contractor

The contractor for the construction of the structure is on the whole the parent company or a firm from the parent firm's group. The experience and record in constructing the kind of structures that are involved in the investment will have an essential effect in reducing budget and construction time risk. Security against this risk is particularly important for the creditors, and will increase their risk to get into the project. If an investor whose core business does not involve building structures, the increased budget and construction time risk will probably be compensated for by a different structure of sources of finance, by reducing the share of debt. If the contract is the parent company, it will provide coverage for the costs of raw materials and the fixed costs of the work while the expected earning (or the major part) is projected onto the period to the conclusion of the existence of the SPE.

7.3 Creditor

In the traditional model the creditor estimates the credit risk on the basis of a number of parameters, the most important of which are market trends in demand for commercial and residential property, the existing credit worthiness of the investor (current indebtedness), the investor's record (necessary to estimate construction budget and deadline risk) and the condition on the long-term loans market from which the purchase price of the structure has to be found. The creditor then first of all finances the construction (usually with a loan of up to three years) and later, if it is the same creditor, will disperse the risk by giving long-term loans (for ten or more years) to purchasers of the structures. The creditor secures itself by entering an appropriate security on the condominiumised housing unit. It is common in practice, experience has shown; that the share of debt in the financing of the end user is very high (often more than 90%). It should also be taken into the analysis that a larger number of loan users will also mean a larger volume and tempo of work for the creditor.

In the case of financing with the use of a BLT model, the analysis procedure is one-off and one long-term loan is given, to the SPE. This is a matter of financing a corporate and not an individual, which means that the structure of the assets of the creditor changes. If insufficient security in the signing of final contracts to lease the structure is presented to the creditor, it will not be inclined to finance the SPE, since the debt servicing has to be financed from the collected rentals. In this case the demand risk is one of the most important risks in a project to supply residential and business premises organised in this way.

The creditor may, in order to provide security against operating risks, require that each entity in the project contractually agrees to an a priori set order of payments. According to the credit lays down a so-called cash water flow or schedule of payments within the frame of which it is possible to define that from each inflow the operating costs of the SPE are first paid, and then the costs of interest on the loan, the principal, other costs to long-term contractual entities in the project and finally the profit of the parent company. It also has to be said that the implementation of the technique of project finance on which the BLT model is based enables a creditor greater and cheaper reduction of the information asymmetry concerning the trends in the cash flow and the value of the assets of the SPE than is the case with traditional models.

7.4 Lessee

The role of the lessee is the central role in the project. Its inclination and ability to pay a rental determines the feasibility of the whole project organised in this way. The corporate lessee can identify benefits that are above all embodied in the corporate's not buying a building or taking on debt to pay the purchase price. The corporate entity will pay the rental and take title of the structure when the last instalment is paid, without a further charge, only on payment of the prescribed real estate transfer tax. Accordingly no debt is recorded in the balance sheet of the corporate, but only a cost in the form of the rental. Further, both legal entity and individual, but contacting the right to reside, are enabled, if circumstances should make it impossible to pay the rental, to sell the residence title/occupancy title at the then ruling market price for the residence title. In this way the existing lessee is

enabled reimbursement of the rentals paid up to the moment it vacates the structure. The motivation for this market arrangement is the fact that title to the structure is transferred to the last lessee with the last instalment of the lease without any extra charge but with the payment of real estate transfer tax on the basis of the value of the land.

7.5 Special purpose entity

The basic role of the special purpose entity is as intermediary for the organisation of the implementation of the project above all by the definition of the role of each entity with respect to the project, their rights and obligations. On the one hand, all the risks are concentrated in the SPE, and on the other, it serves to disperse the risks by the contractual distribution of rights and obligations with other participants in the project. It is important to direct attention the influence of the creditor, in the case of a technique of project financing applied this way, is much greater than the influence and role of the creditor in the use of the traditional model for building residential and commercial properties meant for sale. With the intermediacy of the SPE, it has to be pointed out, the information asymmetry between creditor and owner, owner and management of the SPE, and owner and suppliers is reduced (Esty, 2004).

8 Tax constraints in the application of the build, lease and transfer model

8.1 Tax constraints

The basic obstacle in the way of using the BLT model in Croatia is the implication of the VAT Law for the leasing process and the process of transferring title after the payment of the last rental. The existing laws and regulations concerning VAT¹⁰ do not recognise the unity of leasing and transferring title to the last lessee without charge on payment of the final instalment (“Long term lease for the sale of real estate by leasing – with the possible objective of acquiring title”, or Lease-Purchase or Rent-to-Own).

In the building process the investor receives the interim certificates from the contractors, which the latter send with VAT; for the investor, this sum represents advance payment of tax. According to existing regulations, for real property that is let out for residential purpose it is necessary to correct the advance payment of tax, while for real estate the purpose of which is commercial leasing, this is not necessary. This fact, which according to current regulations makes it difficult to sell residential property to individuals via long-term leases, is prescribed by the provision of Article 11a of the VAT Law, where in Para. 1, Item J it says that the lease of residential property is exempt from the payment of value added tax. Accordingly and in line with Article 20, Para. 3, Item 1 of the VAT Law, the entity liable to the tax cannot deduct the advance payment of tax contained in invoices for received goods and services that it uses for the delivery of goods and the performance of services that are exempt from the payment of VAT.

¹⁰ Fundamental regulations governing VAT are the Valued Added Tax Law (Croatian: *Zakon o porezu na dodanu vrijednost*) and Regulations on Value Added Tax (Croatian: *Pravilnik o porezu na dodanu vrijednost*).

According to the current regulations, if the purchaser were to pay a rental for 10 years, and then determined to acquire the title to the property, the purchaser who has used the lease long-term would again, when acquiring the real estate, have to acquire it at the full price, and the rental paid could not be used for the purpose of mobility if the individual needed to move.

8.2 Current procedure with the calculation of tax and possible procedure in the build, lease and transfer model

Because of the current economic situation, it increasingly happens that completed dwellings meant for sale cannot be sold and remain unsold, after which the investors decide to lease them.

They would not have the right to have VAT paid during construction accepted as advance payment. But again there is a double application of the VAT Law, i.e. for the same category of product, for some of the flats can be leased to corporates as business premises, and some to individuals for residence, so that:

- 1) In the lease of these flats to corporates for business purposes, from the standpoint of VAT, there has been no change of purpose and hence there is no obligation to refund the repaid advance tax paid during the investment process.
- 2) In the case of lease to individuals for the purpose of residence the issue of the right of prepayment of tax that the enterprise has used during the construction is called into question, and this has to be calculated and paid.

An enterprise that would like to apply the model of leasing to individuals instead of the traditional sale must accordingly at the moment of the conclusion of the construction calculate all the prepayment of tax and pay it, which means that the investment is additionally financially burdened, and further transactions are hindered.

The obligation to pay VAT in the case of the real estate starting to be leased is incurred, according to Article 48 of the VAT Regulations, on the expiry of the accounting period in which the conditions authoritative for the deduction of prepayment of tax changed, that is the tax liability is incurred on the expiry of the accounting period in which the enterprise decided to lease the dwellings built, or at the moment of a decision that some dwellings will not be sold at once but will be leased for residential purposes until an interested purchaser should appear.

At this moment it is necessary, according to accounting records only, to state how much VAT has been used as prepayment of tax in the construction of the dwellings (per square metre, in total for each dwelling). If a dwelling is leased for residence immediately after the conclusion of the construction, the VAT that should be paid (or rather the prepayment of tax that has been used refunded) is considered an obligation. The calculated amount of VAT pursuant to the use of the real estate that has been built for the purpose of residence, according to Article 20, Para. 5 of the VAT Law and Article 143, Para. 5 of the VAT Regulations constitutes the operating expenditure of the enterprise in the tax period, which means that the VAT calculated must have an effect on the sales price of these dwellings.

8.2.1 Dilemma in proceeding with the calculation of tax in the sale of real estate the purpose of which has been changed from selling to leasing

When real estate for which it was impossible to deduct tax prepayment is sold, in further sales VAT is not calculated. However, the question arises of whether a newly built property the tax prepayment of which has been corrected for the sake of changing its purpose from selling to leasing/renting, which is sold within a period of 10 years, should have VAT calculated or not, on the basis of Article 2, Para. 1, Item 1 of the VAT Law, or of Article 5, Para. 3 of the Real Estate Transfer Tax Law¹¹ that states: “If the acquirer of newly built buildings has been unable to deduct calculated value added tax as tax prepayment, in further sales these buildings shall be taxed according to the provisions of this Law.”

Since this is real property that has not been put into use, at the moment of the conclusion of the investment only the corrected tax prepayment having been paid, in the event of the cessation of the conduct of the said activity and the change of purpose of part of the building within a period of ten years, the tax payer has the right to a correction of tax prepayment. In line with the provisions of Article 142, Para. 1 and article 144, Para. 2 of the VAT Regulations, if in a period of 10 years from the beginning of the use (a period in which the tax prepayment was or was not deducted) in the enterprise the conditions that define the deduction of tax prepayment change, or if the enterprise in this period has left the VAT system, then the prepayment should be corrected for the period after the change. This means that for VAT used as tax prepayment in a proportional part a liability has to arise, and vice versa, in certain conditions, the enterprise can at a later time use the unused tax prepayment in procurement as tax prepayment. Thus in professional circles and in the tax administration a dilemma has arisen as to whether in the change of purpose of real estate there has been a permanent correction, or whether the real estate if sold in the next ten years will be subject to calculation of VAT on sale, for there has been a change in the activity taxable with VAT.

8.2.2 Possible application of tax in the build, lease and transfer model

Unlike traditional sale of built dwellings in which VAT is calculated and sold at the moment the property is sold, in the BLT model VAT would be paid during the period of exploitation, in the structure of the rental, similar to the PFI model¹² in the delivery of public services.

Because of the various tax positions of the real estate, of the built part and the land on which the structure is built, and where the taxpayer – the deliverer is bound to provide in its accounting records information about the tax bases (not subject to taxation: land and provision of mains services), in the sales contract or the invoice the building value has to be stated separately, as it is the basis for the taxation by VAT and the value of the land as the basis for the taxation by the real estate transfer tax.

On the basis which is formed of the value of land and provision of mains services (on which VAT is not charged) in traditional selling, according to the current regulations,

¹¹ In Croatian: *Zakon o porezu na promet nekretnina.*

¹² Private Finance Initiative.

the purchaser was obliged to pay the 5% real estate transfer tax, i.e. as acquirer, and had to report the incurrance of the tax liability to the office of the Tax Administration in the area in which the real estate lies within 30 days from the day stated in the contract, after which the Tax Administration will send the tax payer a ruling pursuant to which the tax liability needs to be settled in a period of 15 days from the day of the delivery of the ruling setting the real estate transfer tax.

With a change in the real estate transfer tax it would be clearly stated that when the BLT model is employed, the real estate transfer tax would be paid at the moment of the transfer of title to the property (which is the last rental instalment), which in the period of exploitation the deliverer would be obliged in the structure of the rental to calculate part of the delivery as a basis without VAT and a second part with VAT, for it is a matter of "sale in instalments". For the lessee the situation is the same in the two models, with the difference that in the traditional model he pays:

- Real estate transfer tax at the beginning, i.e. the purchase of the real estate, and with the BLT model at the end of the contractual period of the lease, i.e. on the last rent instalment.
- VAT in the price at the beginning, i.e. in the purchase price of the real estate, while in the BLT model he pays it in proportion in each instalment, but on a basis that is greater for the costs of financing. (See Appendix 1.)

In traditional sales the investor makes his earnings by the act of selling, but in the BLT model the earnings are spread out over the exploitation period. Of course, with the development of a secondary market for equity in the SPE, the investor can sell its equity and collect all the discounted future earnings.

Also, according to current models of sale the seller would pay profit tax (corporate income tax) in line with the Corporate Income Tax Law¹³, according to the corporate income made according to the annual tax return from the profit made at once time by comparison of the general costs of procurement of the built real estate and the sales price obtained.

The amount of calculated VAT of 22%¹⁴ or 23% from the supplier in the construction of the real estate at the first moment gives the tax payer (the SPE) the right to deduct the tax prepayment from the tax liability in the calculation period in which it received the delivery; however, if at the moment of the change of purpose the dwellings in the inventories are put into the assets, then there would be no change of activity, rather it would be recorded as operating assets (assets meant for letting, in order to introduce the institute to include rental calculated in this way into the future selling price, which is the so-called long-term lease for the sale of real estate).

9 Proposal to modify the existing regulations

For the BLT model to be justified and for entities in the project to recognise it as useful, it is necessary to change some of the tax regulations; changes can be considered justified on the following rounds.

¹³ In Croatian: *Zakon o porezu na dobit*.

¹⁴ The old universal VAT rate applied from January 1, 1998 to July 31, 2009.

- The BLT model is not a model for the building of a structure with a postponed payment of the purchase price and so from this point of view VAT and real estate transfer tax are not to be paid at the moment the contract is made with the lessee, for there is not sales price for the structure.
- The rental contains the costs of the building of the structure, the finance costs and the investor's profit and from this point of view the rental cannot be interpreted in the same way as with rental that is paid in the model of pure rental without transfer of title.
- The BLT model is feasible exclusively through the intermediacy of the SPE, which in this case is registered only for the activity of building structures and letting them, and when the last rental is paid and the transfer of title takes place, the SPE ceases to exist as a legal entity.
- In line with the interpretation of Eurostat (Eurostat, 2004; Juricic, 2006) an investor in the BLT model assumes the lowest building risk and the lowest demand risk, and in this sense the model can be equated with operational leasing.

According to these points it can be seen that with current regulations in which the VAT Law does not recognise a rental once calculated as part of the sale as part of the market price of the future sale of a dwelling, it does not pay purchasers to acquire a dwelling in this way and participate in the price of future delivery to new purchasers, for they would be paying tax on two bases, that is:

- the first time as price of the lease, which includes the profit and finance costs of the investor, and
- the second time as the market price for the delivery of the real property concerned.

For this reason, for the future employment of this model of sale via the BLT model, it is necessary to harmonise the VAT Law, the Real Estate Transfer Law, the Income Tax Law and the Sale of Dwellings with Tenants' Rights Law.

9.1 The Value Added Tax Law

For the future employment of the BLT model the VAT Law should be modified and adjusted so that:

- The term "Long term lease for residence for sale of title" according to the BLT model is included into the Law, in order to differentiate it from the classic form of rental that is only for (current) residence, so that lease for the acquisition of title is a taxable delivery with a regular rate of VAT – as is the case in operational leasing.
- Article 11a of the VAT Law should be changed, so that this model, "Long term lease for residence for sale of title" is excepted from the exemption to charge VAT as found in Article 11a of the VAT Law, for this is a matter of a sale via an operational lease. This means that the purchaser would pay VAT on the whole value of the lease (market value of the real estate augmented by the finance costs), just as if the purchaser were buying the said real estate by the classic or traditional model of

sale. The budget would not suffer, for the purchaser, whether corporate or individual, would acquire title under the same conditions.

- It would be necessary to put in a provision that a taxpayer, for each investment that is sold in this way, is bound to draw up a calculation at the moment of the completion of the investment, the price to include all costs of building, financing and investor's profit¹⁵, in which case the rental cannot be interpreted in the same way as rentals that are paid in the model of pure rental without any transfer of title.
- The investor is bound in the lease contract, at the beginning of the use of the real estate, present this entire calculation in order for the base for VAT and RETT to be defined. And a proportional part of the investor's profit also makes up a part of the base, although in the contract it need not be displayed in this way. It is, simply, part of the sale price.
- VAT is charged on the rental on that part of the delivery that is for the building part and for the seller's profit, while for the part relating to the land and the connection to mains services VAT will not be charged, and, accordingly, the sum of these instalments of the rental (invoice) in the part of the base that is not subject to VAT would make up the total base for the calculation of the real estate transfer tax, which base the seller was bound to work out according to its calculation.
- The dwelling selling model according to BLT model once applied, it cannot be applied to the same real property in the case of the last corporate lessee that has acquired the property on paying the last rental instalment.
- In the event of the sale of the flat before maturity, the bases for VAT and RETT and the amount of VAT are calculated on the remaining part of the unpaid rentals visible in the basic leasing contract (Rental Contract for the Acquisition of Title, for example), while the conditions for reporting and the obligation to pay the RETT then obtain.

9.2 Real Estate Transfer Tax Law

The Real Estate Transfer Tax Law¹⁶ should be supplemented for the sake of clarifying this model of acquiring real estate in the part:

- By paying the last rental instalment the Rental Contract for the Acquisition of Title would be complete with the last user of the lease, and the BLT seller would then issue title deeds with permission to register concerning the real estate in question, at which moment the obligation to report RETT by the legal deadline would be incurred.
- The last instalment of the payment of the dwelling in his model is not the base for the calculation of RETT; it is just that the acquirer incurs the obligation to pay the RETT.

¹⁵ These costs would not be displayed separately but in a single sum, but it would clear that this sum relates to building costs, financing costs and profit.

¹⁶ In Croatian: *Zakon o porezu na promet nekretnina*.

- The amount of RETT would according to the Law be calculated on the market base of the value of the land shown in the lease or rental contract augmented by finance costs or in line with the market price at the moment of acquisition, according to the same principle as now (since the BLT seller has during the period split off the part of the price that is not subject to the calculation of VAT in every instalment of the rent, which can be distinguished from the calculation of the RETT base that remains in the jurisdiction of the taxation body).

9.3 Income Tax Law

The (Personal) Income Tax Law¹⁷ should be supplemented in the part about the taxation of income from assets and property rights in such a way that specifically the sale of rights from a Rental Contract for the Acquisition of Title (residence right) is stated, that is that if an income is generated from a sale of this right, it is considered a taxable delivery (in the sense of the current Article 27 of the Personal Income Tax Law).

9.4 Sale of Dwellings with Tenants' Right Law

Article 11 of the decision on the proclamation of the Sale of Dwellings with Tenants' Rights Law¹⁸ determines the manner in which the revenue from sale of dwellings with tenants' rights is allocated. From this Law it follows that cities and municipalities that are sellers have a right to part of the revenue from the sale of dwellings that, among other things, they have to devote to the "solution of the housing problems of persons at risk". Article 8, Paragraph 2 of the Socially Subsidized Housing Law¹⁹ defines the opportunity for local self-government units to intend revenue from the sale of dwellings with tenants' rights for the payment of the costs of obtaining building land, infrastructure costs and so on.

It is not clear from this formulation that local units can spend the resources so collected on the payment of rentals in the case of the BLT model being employed. This possibility should be allowed, particularly since in the case of the BLT model this is a matter of the payment of the purchase price of a structure that will become the property of the local unit on payment of the last rental without any charge or without any payment of the real estate transfer tax.²⁰

10 Conclusion

This paper has presented a proposal or model that could be a solution for the financing of new housing projects, for the refinancing of existing projects and improving sales with existing and newly built dwellings. The proposal is based on an organisation in which the technique of project finance is employed. Assuming that creditors are more inclined to refinance existing building loans on unsold properties than to foreclose and sell without the support of long-term purchase loans, the refinanced loans could be coordinated with

¹⁷ In Croatian: *Zakon o porezu na dohodak*.

¹⁸ In Croatian: *Zakon o prodaji društvenih stanova na kojima postoji stanarsko pravo*.

¹⁹ In Croatian: *Zakon o društveno poticanoj stanogradnji*.

²⁰ Unless the relevant provisions of the RETT Law are changed in the meantime.

greater demand if it were based on long-term lease with transfer of title to the property to the lessee on the conclusion of the contractual period of the loan. Demand might be enlarged since the lessees could more frequently change their residences while receiving reimbursement for the rentals paid, which would be much more attractive than the payment of rental without any reimbursement from the new lessee. If the tax laws were changed in the manner proposed here, this is quite probable even in spite of the rent being greater than the traditional rent, for the reasons already stated.

APPENDIX 1: Comparative calculations of rental and annuity

1) Calculation in the case of the traditional model of a dwelling sold on the market

Costs of land and municipal development	10,000
Building costs	70,000
Finance costs during building period	10,000
Investor's profit	20,000
TOTAL COSTS OF THE PROJECT.....	120,000

The base for the calculation of VAT in the traditional model of sale: total costs of the project (120,000) minus costs of land and municipal land development (20,000) equals 100,000. VAT at a rate of 23% comes to 23,000. Total sales price not including RETT is $120,000 + 23,000 = 143,000$. Here one should certainly point out that the basis for the calculation of VAT is 83.33% of the total costs of the project ($100,000 / 120,000 = 83.33\%$).

2) Calculation with the build, lease and transfer model

Annuity for source of finance of 120,000 (total costs of building) over a period of 20 years at 8% annual interest comes to 1,003.11. Of this annuity, 88.33% is taxable with VAT which gives the basis for the calculation of VAT in the amount of 836.44, while VAT itself comes to 192.38. According to this calculation (and the assumption of the change of regulations relating to the calculation of VAT) the SPE monthly invoices rental charges as follows:

Basis of rent that is not subject to VAT plus interest.....	167.29
Basis of rent that is subject to VAT plus interest.....	836.44
VAT (23%).....	192.38
TOTAL RENTAL	1,196.11

3) Comparison of rental and loan

If the purchaser were to take out a housing loan for 20 years at an interest rate of 8% for the purchase of a dwelling the selling price of which is 143,000, the annuity the purchaser would have to pay would be 1,196.11, which is the same as the monthly rental.

4) *Comparison of taxes charged with the traditional model and the build, lease and transfer model*

Table A1: Comparison of calculation and payment of tax

Description	VAT		RETT	
	Traditional	BLT	Traditional	BLT
Amount	23,000	46,171.20	1,000	2,007.48
Basis	Part of the selling price	Part of the rental for the base \times 12 months \times 20 years	Part of selling price for land and municipal development	Part of rental without VAT \times 12 months \times 20 years
Payment	On signing the contract	Proportionally in each rental	On signing the contract	With the last rental

Assumptions for the values in the Table:

- maturity of housing and investment loan is the same and comes to 20 years,
- loans are paid off monthly,
- interest rate on both loans comes to 8% p.a.,
- costs of building are the same,
- in the period of use there is no change in the rate and basis for the calculation of the tax.

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