TAXES ON REAL ESTATE

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In the area of tax legislation, 2016 was a rather peaceful year. It was characterized by stabilization and experiencing previously introduced innovations and their chiselling. Given the fact that this year is election year, we can no longer expect a tax revolution. Even though we have seen attempts in the first few months to make certain changes, particularly in the area of electronic records of sales, there was no "fast-tracking" like we have seen in the past.

INSPECTION REPORT

A major innovation in 2016 that taxpayers had to get used to was the inspection report. From January 1, 2016, all VAT payers have the obligation to submit this report. Although the introduction of this control mechanism was received tumultuously by some taxpayers, it must be noted that after the system was established, there are no significant problems with submitting the reports. The General Financial Directorate is also trying to respond to certain unreasonable penalties associated with the reporting, and is gradually expanding the grounds on which the penalties can be waived.

In practice, however, the procedures of tax authorities associated with verifying information from the submitted reports are the most problematic. A detailed verification of facts that are not important with regard to the overall size of the entity and that cannot ultimately lead to additional tax, can be seen in many cases. We can only hope that the ongoing practice and acquired experience of tax administrators will lead to the abandonment of examining any differences that may arise, and that they will focus exclusively on the essential facts.

A completely new element that we can see in this context consists of "informal" calls and requirements of individual tax administrators sent by email. This poses a dilemma for the concerned payers of how to respond to such calls, especially when the tax administrator sets a deadline for a response that is often no longer than three or four business days.

Legal support for these types of calls is very difficult to find. This practice has developed during the year so that if the taxpayer does not respond to such a call in any way, the tax administrator repeats the same demand through "standard" methods governed by law. On the other hand, reacting to the tax administrator's informal email call may speed up proceedings in many cases, and may alsolead to a faster refund or termination of the procedure without further examination. In any case, it is recommended that any response to this type of call should be made by standard means, therefore preferably via a data box or regular mail.

TAX ADMINISTRATOR PROCEDURES

In connection with tax administrator procedures, we can continue to expect increasing efforts to increase state budget revenues using existing legal means in 2016. This goal is reflected in the current policy of the Czech Ministry of Finance and partial amendments, which are either planned or have already gone through the legislative process.

Measures supporting the established policy in the coming period will particularly include:

- Specialized tax audits
- Consistent application of the possibilities of current legislation
- Emphasis on transfer pricing
- Continued changes in reverse charge for local fulfillment
- Introduction of electronic records of sales (EET) in other areas.

SPECIALIZED TAX AUDITS

In 2017, we can expect that initiated tax audits will usually not deal with all tax areas. They will focus on the areas in which they can expect an increased probability of detecting tax arrears, or possibly a serious violation of tax rules. Tax audits are generally also not initiated on a random basis, but on the basis of evidence found directly in tax claims and their annexes, inspection reports and newly also from the EET system.

Given the increased number of initiatives, we can see a gradual transfer of the control function to other parts of state administration as well, specifically customs administration, which, in addition to managing excise taxes, will also have the responsibility of inspecting the function of the newly introduced electronic record of sales.

Other procedures directed at higher tax revenue include the sharing of information and procedures between individual tax authorities. There is a significant shift particularly in the knowledge and specialization of inspection staff. Different types of additional tax assessments are discovered in taxpayers in certain periods, regardless of their regional affiliation. It is therefore clear that "successful" procedures are applied by tax administrators throughout the country.

CONSISTENT APPLICATION OF THE POSSIBILITIES OF CURRENT LEGISLATION

This policy primarily includes increased control over tax collection. Tax administrators are trying to use procedural methods that we have only seen rarely in the past. For example, we can increasingly see a tax securing institute through tax distraints.

Although this was used more as a last resort in the past, its popularity among tax authorities is increasing,

which is also based on the increased number of judicial decisions. We also see tax distraint among ordinary taxpayers in the course of a tax audit, when a tax that is yet to be levied is distrained!

It is also used to enforce the payment of tax arrears in respect of penalties or interest on arrears, in a very short period after their amount is announced. Defense against such an act by a tax administrator is very difficult and basically unattainable in a short timeframe because of the length of judicial proceedings.

TRANSFER PRICES

Thanks to internal communication between state administration divisions, tax audits focus on specific areas that may be associated with the greatest risk of additional tax assessment. The main area that they currently focus on are transfer prices.

In relation to the verification of transactions and prices in the group, tax administration had previously introduced the obligation to report the volumes of transactions executed between related parties. It requires this in the form of an annex to the income tax return. The data contained in this annex may identify entities with a significant proportion of transactions in the group.

The information in the presented annexes is extensive, and tax administrators acquire information this way over several years. They are therefore able to create a fairly accurate picture of the state and structure of the entity's management, as well as of the importance of intercompany transactions.

The structure of the group, divided into individual subsidiary real estate companies with one or more service companies, is used quite often in the real estate sector. Individual real estate companies cover separate development projects or their stages. The service company then provides the operating functions of these "subsidiaries" or "spv".

Services provided within the group and their pricing can bring significant risks in terms of demonstrating the use of market prices.

In order to avoid these risks, it is recommended to prepare documentation supporting the pricing of internal transactions. The submission of these documents during a tax audit transfers the burden of proof to the tax administrator. It is then up to the tax administrator to provide evidence questioning the established transfer prices in terms of both methodology and other conclusions resulting from such documentation.

BEPS AND ITS IMPACT

The policy of the Ministry of Finance is based on international activities aimed at eliminating and preventing tax evasion. The plan of action was approved by the BEPS initiative. The specific impacts of this initiative can be followed in the amendments to EU legislation. Under the influence of these two factors, these amendments also affect Czech entities. This includes the following areas:

- **Country by country reporting**
  This new rule is based on Directive 2011/16/EU, regulating the automatic exchange of information in tax matters. In Czech legislation, this provision is reflected in the amendment to the Act on International Cooperation in Tax Administration, which shall come into effect in June 2017.

  This creates the obligation for certain groups with international operations to give the tax administration information on its foreign activity/company. This way, even Czech entities owned by multinational groups may be obligated to submit the required information.

  Therefore, in an attempt to monitor the establishment of transfer prices, this instrument provides the additional transfer pricing documentation that is recommended in the Czech Republic and mandatory in other countries, on a global and local level (Master file and Local file).

- **Anti-Tax Avoidance Directive (ATAD)**
  The new ATAD directive should be implemented in EU member states from January 1, 2019, and it should replace existing thin capitalisation rules. It will restrict the deductibility of any interest costs exceeding the limit (currently proposed in the amount of 3 million EUR), which will now depend on the EBITDA value. The specific conditions of this regulation are directed by individual member states. The proposed limit in the Czech Republic is currently in the amount of 30% EBITDA.

  Another tool based on the mentioned directive are rules for controlled foreign companies - CFC rules. This means that the profits of the controlled foreign company can be attributed to its parent company residing in an EU member state. The condition for applying these rules is at least 50% ownership stake and the fact that the profits of this entity are subject to an effective tax of 50% less than would be the case in the state of the parent company.

  Another area in which the impact of the ATAD directive is apparent is the limitation on the use of hybrid structures, not only in the EU, but also for transactions to countries outside the EU.

EXPANSION OF THE LIST OF PERFORMANCE SUBJECT TO REVERSE CHANGE

The extension of the use of reverse charge for the provision of workers for construction and assembly work is one of the few approved new regulations that is already in effect for 2017. This includes "agency employment".

In this context, it is necessary to mention the efforts of the Czech Ministry of Finance to use reverse charge on the widest possible amount of taxable transactions between taxpayers. Although this effort faces opposition from several other EU states, further expansion of the reverse charge procedure, at least in pilot projects, is not out of the question.

TAX NOVELTIES IN THE REAL ESTATE SECTOR

VALUE ADDED TAX FROM 2016

Last year, we informed about the amendment to the Act on Value Added Tax for the transfer of land and buildings on the Trend Report website. Although the content of the amendment was known a long time before it became effective, it has generated and still generates lively debate over the method of its application among professionals, and therefore continues to be a source of a number of uncertainties.

The effort of a number of lawmakers to amend this provision and return to the rules that were in force in recent years is also evident, particularly the effort to re-extend VAT exemption for certain types of undeveloped land.

Currently, a package of amendments to tax laws, which was to originally become effective in January 1, 2017, was returned to the Chamber of Deputies by the Senate with an amendment in this direction.

Another novelty that is already in force since 2016 is the regulation on the application of VAT on the transfer of immovable property, where the taxpayer decides to apply the VAT in accordance with applicable law, although the conditions for exemption are fulfilled. The Act on VAT currently contains an arrangement whereby if immovable property is acquired by the taxpayer when VAT is voluntarily applied, reverse charge will be used.

Although in some situations this approach clearly contributes to simplification and savings in terms of the buyer's cash flow, the inability to apply reverse charge for real estate in general and the need to examine the conditions for its application complicates the situation again. The culprit of this condition in not the Ministry of Finance; European rules do not allow reverse charge in the transfer of real estate.

TAX ON THE ACQUISITION OF IMMOVABLE PROPERTY

An important regulation brought by 2016 in the tax on the acquisition of immovable property is the change of the taxpayer. This regulation has been prepared for a long time, but its statutory regulation was only enforced at the end of last year.

It is no longer possible for parties to agree who will pay the tax on the acquisition of immovable property, as was the case in the past. Following the new regulation, the institute of liability for unpaid tax was also abolished. The problem of the seller's necessity to take into account the tax on the acquisition of immovable property, if the parties agreed that the seller is the taxpayer, was also removed.

On the contrary, there was no shift in the issue of including value added tax in the agreed price for calculating the tax on the acquisition of immovable property. Despite continuing controversy, the government has an unchanging view of this issue, where the agreed price and the basis of the tax on the acquisition is the price including VAT.

Other changes and regulations of the tax on the acquisition of immovable property brought by the mentioned amendment concern the following:

1. The subject of the tax:

- It was specifically amended that the subject of the tax is not the acquisition of ownership rights to immovable property by the transformation of legal entities, with the exception of the transfer of assets to a shareholder.
- Now even the extension of the period for which the right to build is established is considered as the acquisition of ownership rights to immovable property, which is subject to the tax on the acquisition of immovable property.
- The acquisition of parts of utility networks that are not a building according to the Cadastral Act (e.g. the acquisition of water and sewer pipelines), is now not subject to taxation. Only acquisition consideration of ownership rights to a building according to the Cadastral Act, which is part of the utility network, is subject to taxation.

2. The application of taxes on the exchange of real estate:

In an exchange, there is an expanding number of situations where it is not necessary to take into account the value of the immovable property in determining the agreed price for purposes of the acquisition tax. It is therefore possible to only use the exchange value as a reference value for tax purposes.

3. Changes in the exemption of new buildings and units:

- Exemption will only apply to the first acquisition consideration of a completed or used family house or unit in an apartment building. This exemption does not apply to the acquisition of a building or unit that is under construction.
- The mentioned acquisition of ownership rights to immovable property is only exempt from the tax on the acquisition of immovable property if it occurs within 5 years of the date of completion or initiation of use.

CORPORATE TAX

The amendment to the Act on Income Taxes, which was originally to come into effect on January 1, 2017, was delayed in the legislative process. It could come into effect on April 1, 2017. However, the amendment was returned to the Chamber of Deputies by the Senate in early March, and the ultimate fate of the amendment is uncertain at the moment.

The most important change is the adjustment of the possibility of tax depreciation of capital improvements, in the same way for both the tenant and the subtenant. If this amendment is approved, the subtenant could claim the value of tax depreciation of capital improvements made to the sublet property as tax deductible expenses. This would answer the numerous calls of users of leased spaces, who complain that the existing restrictions worsen their position in concluding (sub-)tenancies.

Another proposal is the specification of the entry price for determining tax depreciation for new construction. The entry price of new assets includes the residual value of the assets, retired in connection with this new acquisition. In practice, these are particularly cases of demolition in order to make room for new construction. The proposed amendment stipulates that in order to determine the entry price forming the basis for calculating tax depreciation, it is necessary to include the tax residual value of the assets being retired.

The upcoming amendment should include one more change. Under the proposed statutory regulation of the depreciation of intangible assets, the depreciation provided for by law should be treated merely as a maximum value. It should therefore also be possible to apply lower depreciation.

In connection with changes in income taxes, it is also worth mentioning the repeal of the Act on Lotteries. Up until now, it indirectly affected the tax deductibility of advertising costs, expended in connection with the promotional activities of taxpayers. The options and particularly the amount of winnings in advertising competitions have been significantly reduced. The new definition of consumer competitions contained in the Consumer Protection Act brings new possibilities for marketers. They may also have a positive impact on the tax deductibility of related costs.

ONE-CROWN BONDS

The tax benefit of one-crown bonds issued by the end of 2012 and held by a related entity, consisting in the favourable rounding of the tax base and therefore the exclusion of the interest income tax, seems to be coming to an end in connection with the proposed amendment to the Income Tax Act. The amendment to the Income

Tax Act, which is discussed in the Chamber of Deputies, should conform the taxation of these bonds to the current regime, where the tax base is not rounded. However, the fate of this amendment is uncertain. In order for the amendment to actually come into force, it must go through the entire legislative process during the current electoral period. Even in this case, we can expect a motion to be filed to the Constitutional Court to repeal the amendment due to the retroactivity of its effectiveness.

In the next period, it will therefore be interesting to follow the development of this amendment and especially the proceeding of tax authorities, who started number of tax inspections of issuers of these bonds recently and review in details the circumstances of their issuance and use of the financial means received in this way.

CURRENT RISK ISSUES

The described tax adjustments are not the only ones. Moreover, a number of other changes are in the making or are being discussed due to ambiguous interpretation. We therefore think it is beneficial to introduce readers of Trend Report to at least those changes that are directly related to the real estate market.

DEBT PUSH DOWN

This is a situation where a tax administrator sees the abuse of rights in the deduction of interest on a loan, granted by a related party for the purchase shares in companies, acquired in the context of intragroup reorganization. Situations where intragroup reorganization is carried out with the primary goal of achieving tax deductibility of interest on acquisition loans are then assessed as situations that cannot provide the desired result when other economic reasons for the transaction are missing.

The most important factor is the entity's ability to demonstrate its compliance with all requirements and standards for the restructuring. In current case law, we can identify cases where no particular economic reason was demonstrated. The entire restructuring process was therefore judged as being implemented solely to obtain tax benefits. In other words, the procedure was judged as legal abuse. Ultimately, the tax administrator does not consider the costs associated with the restructuring as tax deductible.

PAYMENT OF FUNDS FROM RETAINED EARNINGS

In connection with company transformations, valuation differences are often overvalued and accounted for through various balance sheet items. Although this option is possible from the perspective of Czech accounting standards, it is questionable whether this accounting treatment may affect the tax treatment applied on payday.

In 2016 this issue was discussed lively at a joint meeting of representatives of the Czech Ministry of Finance and the Chamber of Tax Advisors. The complexity of this issue is evidenced, among other things, by the fact that the topic remained open longer than usual, and conclusions were repeatedly amended.

Finally, the Ministry of Finance took a stance on this issue, where the deciding factor in determining the tax treatment is the method of the emergence of the component paid from equity. The valuation difference resulting from the overvaluation was not created from profit, but due to the merger. Therefore, according to this view, it is not possible to apply exemption from the payment of valuation differences in this case, since it is not the kind of income that is exempt according to the law on income tax.

INCIDENTAL RENTAL EXPENSES

The current question that we have recently encountered not only with clients, but also in judicial decisions, is the assessment of incidental performance as part of the main performance for VAT purposes in the relationship between the landlord and tenant.

In cases where other services are provided to the tenant in addition to the lease, the question arises whether these services should be considered as independent performance, or as part of the performance and/or as performance incidental to the lease, which would be subject to the VAT treatment of the main performance. In practice, this includes the billing of cleaning, security or energy consumption in common areas, and possibly also insurance or real estate taxes.

These are particularly cases when a tenancy is agreed with a tenant who does not pay VAT, or who is limited in claiming a deduction.

It is clear from previous experience that the assessment of whether it is independent performance of incidental performance is not clear, and it is necessary to approach each case individually. However, it is evident that some of the above items that were previously assessed as separate performance may be factored into the tax base in the rental of real estate. In relation to the case law of the Court of Justice of the European Union, we can therefore expect tax administrators to focus their attention on this area.

OBSTRUCTION DURING REGISTRATION

The strengthening of the impact of control mechanisms against tax evasion is also applied by financial administration in the registration of new companies for VAT. In an effort to prevent the application of unjustified claims to VAT deduction, the future activity of the company applying for registration is reviewed in detail in the registration process. This process can therefore significantly extend the time necessary for voluntary VAT registration. During the registration, tax administration often requires the submission of documents and information that may not be available at the given moment (future lease agreements, contracts, orders, etc.).

Unfortunately, this practice of tax authorities must be expected in advance. The extent of the audit is always dependent on the requirements of the specific registration department employee, and the registration process can therefore be greatly extended.

CONCLUSION FOR THE FUTURE

The current situation in the taxation field implies the preparation for the upcoming election year, waiting for individual involved persons and looking for the most suitable pre-election position or post-election promise, rather than conceptual support of selected areas. However, we believe that we will be able to present more positive news in the 2018 Trend Report, which could give this dynamic sector of our economy a new impetus for further development. It will also be at least partly clear how the future tax development will be affected by the results of the elections, and what framework changes we can expect in the next few years.

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