TAXES ON REAL ESTATE

TAXES ON REAL ESTATE

Election years are usually calm and waiting periods in terms of the development of taxes. 2017 was no exception, but the beginning of 2018 already shows that there will definitely be significant changes in the next term (particularly in 2019), and not even the long activity of the resigned government is an obstacle to them. It is necessary to admit, though, that some of the upcoming changes that may also affect the real estate market consist of the compulsory implementation of European Union regulations, especially Council Directive (EU) 2016/1164 ("ATAD directive").

TAX TRENDS IN THE REAL ESTATE SECTOR

In 2017 there were basically no legislation novelties that would directly influence the real estate sector, besides the option of tax depreciations of capital improvements to the sublet property. New approaches and the search for new activities in this sector have a greater impact on the real estate sector than the change in tax legislation. In terms of taxes, they bring new solutions and matters that have not been addressed before.

Rental housing

The example of a new activity is the shift towards more frequent rental housing. It is not only clear for natural persons as an alternative option of investment, but also for developers who are considering the use of the constructed housing units for renting already in the planning stage of new projects.

For natural persons in the Czech Republic and neighbouring countries, there is a clear tendency to provide short-term rentals through websites that provide this kind of activity. As a result, the tax authority becomes more and more interested in persons providing such rentals. Also, a lot of questions related to the tax treatment of these activities arise.

For legal persons, the tendency to provide rental housing means the necessity of a diligent approach to the application of the right to deduce VAT and the increasing demands on long-term tax planning. The unsuitable setup of a rental structure may then bring higher costs in the field of VAT and turn a revenue generating project into a loss.

Tax on the acquisition of immovable property

Changes in terms of the tax on the acquisition of immovable property are not caused by changes to relevant regulations but by judicial decisions. In the specific assessed case, the basis for the calculation of tax on the acquisition of immovable property was the price that was agreed upon by both the seller and the buyer. As this transfer was subject to VAT, there was a question about including this VAT in the tax base for the calculation of tax on the acquisition of immovable property. Although the Financial Administration took a long-term view that the related VAT is included in the agreed price while it relied on the explanatory memorandum to this statutory regulation, the Supreme Administrative Court decided that VAT shall not be included in the tax base for the calculation of the tax on the acquisition of immovable property.

With regard to the fact that the Supreme Administrative Court decided consistently and similarly in a short period in two different cases, the Financial Administration accepted this judicial practice. The Financial Administration subsequently published the information that the conclusions of the judicial decisions can be applied to both newly submitted tax returns and to already submitted tax returns to which additional tax returns can be supplemented. It was also confirmed that the conclusions can be applied to cases in which both the acquirer and seller are VAT payers.

ATAD DIRECTIVE

Significant changes to the corporate income tax will come in 2019. The biggest changes will be related to the above-mentioned implementation of the ATAD Directive. It can be assumed that a limitation in the deductibility of excessive borrowing expenses will particularly hit the real estate sector, which mostly uses external financing resources. This is why it is necessary to devote the required attention to this area and to include the consequences arising from the new regulation in long-term plans as soon as possible. Particularly in the case of big projects, we can assume that the limits set by the mentioned amendment to the act on income tax will be reached.

The primary basis of the ATAD directive, which must be implemented in the Member States of the EU on January 1, 2019, is to restrict tax avoidance by transferring profits or activities to other states with lower levels of taxation. The amendment to Czech tax regulations, particularly the act on income tax, which includes the requirements of this directive, was in the so-called external amendment procedure when this text was being prepared. It can be assumed that in the course of May the Chamber of Deputies of the Parliament of the Czech Republic could discuss it in the first reading.

The directive mostly focuses on the following areas:

- The deductibility of borrowing expenses
- The rule against the abuse of law
- Controlled foreign corporation (CFC)
- Hybrid instruments
- Exit tax

The arrangements described below should take place on the basis of the amendment to the act on income tax, which implements these rules in local legislation.

Limitation to the deductibility of excessive borrowing expenses

The current tax arrangement limits the deductibility of financial expenses (mainly interests) primarily by rules of so-called thin capita-

lisation, but only financial expenses related to financing by related parties are subject to this limitation. Such limitations are insufficient according to the ATAD directive, which is based on the existing practice of some EU states (such as Germany).

The directive and the draft bill amending the act on income tax therefore extend this limitation of the deductibility of financial expenses to the costs of financing, regardless of the fact if the base (financing) instrument is provided by a related party or not. The new arrangement will also limit interest expenses from bank or bond financing.

However, limitation in the form of low capitalisation will be preserved. Financial expenses from financing by related parties will therefore be subject to double testing with regard to their tax deductibility – the test of low capitalisation, and (if they could be considered tax-deductible on the basis of the low capitalisation test) a further test according to new legislation will follow. These items will be newly subject to the limitations even if they are only included in the costs indirectly (for example, in the form of write-offs) in the case that financial expenses are capitalised in the acquired property.

The limitations will also be applied to interest expenses and other costs related to financing, which, from the economic point of view, are equal to interests or costs incurred in relation to the acquisition of financial resources including costs related to their securing. This can also include capitalized interests, charges related to financing, the interest element of financial leasing, guarantees related to financing or exchange differences. The new arrangement will then test net financial (borrowing) costs, i.e. costs reduced by a similar type of financial revenues.

However, the amendment only focuses on larger projects. If the net amount of the defined borrowing costs does not reach 80 million CZK in one accounting period, the new amendment will not be applied. This limit is the maximum amount that the ATAD directive allows. Even though the limit of 80 million CZK could seem sufficient with the current low interest rates, the increase of interest rates in the future might draw this limit closer even to mid-sized real estate projects[1].

80 million CZK is the suggested limit for an individual taxpayer (company) regardless of other companies in a group. Dividing individual projects into separate companies can thus have another reason.

In cases in which this limit of net borrowing costs is exceeded, a next test, i.e. a comparison with the net income in the given accounting period, will be taken in order to assess the tax deductibility. If the net amount of financial borrowing costs exceeds 30 % of EBITDA, the borrowing costs in the given accounting period will not be tax deductible.

The use of EBITDA to determine the limit for tax deductibility does not seem to be the best solution from a practical point of view, and also because of the fluctuations of this indicator (especially in the first years of some real estate projects). However, on the basis of the practice in some Member States, the directive does not allow any other option. The option of transferring the value of potential tax non-deductible borrowing costs to next tax periods (without time restrictions) and their application for a reduction of a tax base under set conditions can be a certain mitigation of this rule and compensation for the fluctuating comparison base.

A substantial complication for the application of transferred borrowing costs to the future is the impossibility to transfer them if the taxpayer ceases to exist due to a company conversion, e.g. its fusion with another company. The current bill does not include the option of transferring tax losses to the recipient company, which is allowed by current regulation. Complications caused by such regulation, for example, when selling larger real estate projects to new investors, are therefore obvious.

The general rule against the abuse of law

The statutory regulation preventing abuse of the law is no novelty in Czech tax law. Czech courts have already confirmed the principle that tax benefits cannot be applied in the case where the only reason for executing a certain specific transaction was gaining such a tax advantage.

Anchoring this principle directly into the tax law, as the discussed amendment proposes in response to the ATAD directive, is significantly strengthened by the authorisation of the tax authority in this area. One of the fundamental aspects is the extension of the definition of the abuse of law also for transactions in which gaining a tax benefit is not the only reason but one of the main reasons. In order to refuse the tax benefit, the tax authority will only need to prove that the motivation of the tax payer to execute a certain transaction also lied in gaining a tax advantage.

The threshold for the proper application of tax regulations and the potential abuse of law therefore becomes even more blurred than it is at present. Poor jurisprudence in this area will definitely lead to the considerable uncertainty of tax payers and potential uncertainty for some transactions, or the use of some structures that are currently common, whether they are various company conversions or the use of foreign structures of holding companies.

Tax administration therefore receives another tool that simplifies the additional assessment of tax. The rectification of incorrect use of such a tool will only be possible with judicial actions brought before an administrative court, which is a considerably time-consuming solution. Moreover, it is necessary to mention that even if the decision of the tax authority is subject to an action brought before an administrative court, the additional tax is still payable and the cancellation of such a decision can take three or more years, depending on the specific court.

Controlled foreign corporation – CFC rules

This new principle introduces the possibility of taxation of retained earnings of a controlled foreign corporation in the state of a parent company. These rules can therefore apply to Czech companies that have subsidiaries or a permanent business residence in another state (which is rare) if the subsidiary (or permanent business residence) is subject to taxation with a tax rate that is at least 50 % lower than in the Czech Republic[2].

[1] At an interest rate of 5 % p.a., the limit accounts for the principal of 1.6 billion CZK – however, it is necessary to take into consideration the fact that not only interest costs are included in testing.
[2] Currently, such a state should have an income tax rate applied to specific corporates amounting to 9.5 % or less – let's compare it with Hungary, for example, which currently applies a corporate income tax rate of 10 %; this is very close to the given limit.

The condition for the application of these rules should be the fact that a subsidiary (or a permanent business residence) does not perform a substantial economic activity. The draft bill amending the act on income tax does not specifically include the definition of such economic activity, and there are therefore various options for applications that will be reduced by the requirements of the directive.

If such a subsidiary exists, its profits will be subject to taxation both in the home state and in the Czech Republic according to Czech tax legislation. The tax paid in the home state can then be deducted from the Czech tax obligation.

Hybrid mismatches

Another area addressed in the EU Directive and that will be reflected in the amendments to the local tax laws is the area of the solution of hybrid mismatches. These are situations that arise from different legal qualifications of entities, financial instruments and permanent business residences in individual states.

The differences are in the assessment of the transparency of the same entity according to the legislations of various states, or in the assessment of interests that can be called dividends according to the legislation of various states, etc. As a consequence of such mismatches, one of the aspects of using such hybrid structures can be gaining a certain advantage with regard to taxes.

Although it is probably possible to address such mismatches through implemented measures against "abuse of the law", the draft bill of the amendment includes a special arrangement that should come into effect a year later – i.e. on January 1, 2020. The subject of such an arrangement should be the elimination of mismatches occurring both among EU Member States and also among third countries.

The solution of such mismatches then depends on the specific features of a specific case. The solutions can be summarised in the following procedures:

- If there is a possibility of a double deduction of costs in the source country and in the recipient party, the deduction should be denied in the recipient country.
- In the case of the deduction of the costs in the source country without the taxation of income in the recipient country, deduction in the source country should be prohibited.

The application of these rules in the case of a mismatch in countries outside the European Union will probably be difficult. We can assume that tax authorities will aim to prohibit the use of these structures using general rules related to abuse of the law. In this context, it is necessary to note that the Supreme Administrative Court has already decided for cases in specific contexts in a similar way.

Exit tax

For completeness' sake, it is also necessary to include another instrument introduced by the ATAD directive, i.e. the principle of the exit tax. This institute lies in the principle of applying tax when assets are transferred abroad, provided that the owner remains the same but the source country loses the right to impose a tax on these assets. It can be assumed that this principle will be applied by production companies rather than in the field of real estate.

This newly introduced rule should come into effect on January 1, 2020, and it should include the transfers of assets both inside and outside the EU. The tax base should be determined as the difference between the market price and the residual tax value of concerned assets.

Other areas affected by the amendment

Contrary to previous years, we would also like to mention the expected impacts on natural persons related to real estate. Besides the above-mentioned aspects, the mentioned amendment to the act on income tax also introduces a change to natural persons' income tax rate. The income tax rate for natural persons will increase from 15% to 19%, and it introduces a tax rate of 23% (and some draft bills also mention 24%) for a tax base exceeding 1,500,000 CZK.

A partial compensation for this should be provided by the possibility to deduce 75% of expenses for health and social insurance from the tax base. There will be no compensation for incomes that are not subject to insurance. This will also concern taxes on rental income.

If the lessor (a natural person) is subject to the higher tax rate of 23 %, it will cause a significant increase in his/her tax burden. The question is if this approach contributes to the considerations of the use of legal persons' tax rate, which remains at 19% in the amendment. In relation to this issue, the professional public is discussing whether the higher tax burden of lessors will be reflected in rents, or whether it will put pressure on the price of investment apartments.

TAX ADMINISTRATOR PROCEDURES

From the perspective of the approach of tax authorities, we can expect the established trend of the maximisation of state budget revenues using existing legal means to continue in 2018. Similarly to last year, we can particularly expect activity in the following areas:

- Specialized tax audits
- Consistent application of the possibilities of current legislation
- Emphasis on transfer pricing

Specialized tax audits

In 2018 we can expect the trend of clearly focused tax audits to continue. The already started tax audits, which cannot be finished within one year due to their extent, will also continue. It can also be expected that the newly started audits will be liable to the current development in society. This trend can be pointed out on the basis of a comparison of topics largely covered by the media and currently starting or ongoing tax audits. We can give an example of audits focused on tax consequences of issuing one-crown bonds.

Other procedures that lead to the goal-directed course of audits and securing "a better" result can also be identified on the side of tax administrators. Other procedures include the sharing of information and procedures between individual tax authorities. Particularly the knowledge and expertise of staff carrying out the audits are much better than they were in the past, because individual types of additional tax occur for taxpayers in certain periods regardless of the region. It is therefore clear that "successful" procedures are applied by tax administrators throughout the Czech Republic.

Consistent application of the possibilities of current legislation

This policy primarily includes increased control over tax securing. Tax administrators make use of procedural processes, which was rather rare in the past for tax securing. For example, we can increasingly see a tax securing institute or using tax distraints. Both procedures were largely covered in media in the last year.

Although this was used more as a last resort for tax securing in the past, it is evident that its popularity among tax authorities is increasing, which is also based on the increased number of judicial decisions. We also see a tax securing institute among ordinary taxpayers in the course of a tax audit. Tax that is yet to be charged is often secured and possibly also distrained, or this only happens shortly after the notification of tax arrears in respect of penalties or interest on arrears.

Defence 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. On the other hand, it was evident in the last year that in the cases of big excesses of tax authorities, the procedures are denied by administrative courts. The same trends are confirmed by court decisions from the beginning of 2018.

Transfer prices

Tax audits focus on specific areas that may be associated with the greatest risk of additional tax assessment. The core areas are the same as in previous years – transfer prices.

The obligation to report the volumes of transactions among related persons through individual annexes to tax return also serves the tax authorities to identify the taxpayers, which should be the concern of a tax audit. Since there is quite a lot of information in the submitted annexes and the annexes are submitted for several years, the tax authority is 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 subsidiaries with one or more service companies is used quite often in the real estate sector, where individual real estate companies cover separate development projects or their stages. The service company then provides the operating functions of these companies. The benefits of this structure for potential transactions with projects are clear. However, this also means that the services provided within the group are the basis of functioning, which might bring significant uncertainties in terms of proving the use of market prices. Even though the burden of proof in the area of transfer prices lies primarily on the side of the tax administrator, the procedural situation of the tax administrator in relation to submitting the documentation related to transfer prices in a tax audit is not only limited to the confirmation (setting) of the transfer price, but it can also prove the inaccuracy of the submitted documentation.

OTHER CURRENT TOPICS

Debt push down as a means of real estate project acquisition still remains in various stages of completion. This procedure is linked to the concept of abuse of the law to a certain extent. This means situations in which the tax administrator can see abuse of the law in the expediency of such a procedure, particularly in intercompany reorganizations.

The substantial risks of the described procedure are being discussed. The most important role is the entity's ability to prove that the requirements and standards for restructuring were fulfilled, especially from the perspective of economic reasons.

PROSPECTS FOR THE FUTURE

Last year we used this space to express our expectations of only positive news with regard to taxes. And even though no turbulent measures or amendments were adopted, also because of the election result, we cannot say that our expectations were fulfilled.

The future is therefore probably going to bring (also under the influence of EU legislation) stricter tax rules and an emphasis on eliminating possible tax optimisation solutions. Administrative courts may mitigate the excesses of tax administration, the tax legislation will continue to support the income taxation in jurisdictions where these incomes gained from business activities are created. The real estate sector will be no exception with regard to this, and the limitation of tax deductibility of borrowing costs, for example, may be one of such measures.

PETR TOMAN, PŘEMYSL KLAS
KPMG Česká republika, s.r.o