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Real Estate Investments: Czech Republic

The tax and legal aspects of real estate investments around the globe

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Real estate investment in the Czech Republic

Basic principles

Introduction

The real estate sector in the Czech Republic is experiencing a renewal of interest from investors after the global credit crisis. However, there weren't any other tax legislation amendments approved in 2011 to significantly effect the real estate sector.

Taxation

When investing in real estate in the Czech Republic, the following key points should be considered:

- In principle, Czech legal entities, Czech branches of foreign companies, and European union (EU) individuals and entities may directly acquire Czech real estate, although certain restrictions remain in place.
- The general Czech corporate income tax rate for 2011 is 19%.
- Tax losses may, in principle, be carried forward for five tax periods immediately following the tax period in which the tax loss arose. This period was seven years for losses incurred prior to 2004.
- Certain restrictions on the ability to redeem losses apply if there is a substantial change in the ownership of a company.
- There is no carry back of losses in the Czech Republic.
- Tax losses cannot be set off against the profits of a group company.
- Dividends and interest payments are liable to 15% withholding tax (WHT) (this rate may be reduced by a double taxation treaty, if applicable).A 0% WHT applies to qualifying dividend distributions and interest payments, in accordance with the EU Parent-Subsidiary and Interest-Royalties Directives.
- Both realised and unrealised foreign exchange differences are subject to corporate income tax (CIT) in the tax period in which they arise.
- Real estate transfer tax is generally charged at a flat rate of 3% on the transfer of ownership title to real estate.
- No capital duty is levied in the Czech Republic.
- Thin capitalisation rules allow a debt-to-equity ratio of 4:1 for loans from related parties to restrict tax-deductible financial costs.

Legal aspects

Due to foreign exchange restrictions, foreign companies that wished to acquire Czech real estate have, in the past, established or acquired Czech companies. This restriction was based on special conditions agreed between the Czech Republic and the EU, i.e. a seven-year transition period applies since the Czech Republic joined the EU in 2004. Since May 2011, the only restriction on acquisition applies on sale of agricultural land and forest from the property of the Czech state.

Ownership of real estate can be acquired through, e.g. a purchase contract or donation, a contribution to a company, or inheritance.

A contract for the transfer of real estate must be in writing and the signatures must be verified. If real estate is transferred on the basis of a contract, ownership is acquired by its registration with the Real Estate Cadastre, according to specific regulations governing such a transfer (unless a special law provides otherwise).

Review of ownership titles is an important component of legal due diligence in the Czech Republic, because of the transformation of real estate evidence in the Czech Republic in the early 1990s and the previous regime, during which ownership rights were not properly entered into books.

Investing through a local entity

Methods of acquisition

An investor may either establish a Czech legal entity that will directly acquire the real estate or acquire shares in a Czech special-purpose company that owns the property.

It is advisable to conduct a thorough due diligence review of the target company before acquiring its shares. In such a due diligence review, the legal, financial and tax positions of the company should be examined. Generally, the seller should be asked for certain representations, warranties and guarantees regarding the legal, financial and tax position of the company.

Choice of entity

Under the Czech Commercial Code, the following Czech legal entities may be established as business entities:

- General partnership (verejna obchodni spolecnost).
- Limited partnership (komanditni spolecnost).
- Limited liability company (spolecnost s rucenim omezenym).
- Joint stock company (akciova spolecnost).

All four types of entities may hold real estate, even if they are fully owned by foreign entities or foreign individuals.

A limited liability company and a joint stock company are the most frequently used types of companies for holding real estate. A limited liability company may be founded by one or more resident or non-resident persons (the maximum is 50), who may be either legal entities or individuals. The minimum registered capital required for new limited liability companies to be founded is CZK200,000. The minimum investment by a participant is CZK20,000.

Czech law includes a restriction on the ownership of limited liability companies that prevents a limited liability company with a sole shareholder from acting as the sole shareholder of a Czech limited liability company (so called ‘anti-chaining law’). The general interpretation is that this restriction also applies to foreign limited liability companies.

A joint stock company may be founded by one founder if this is a legal entity; otherwise, a joint stock company can only be founded by two or more persons. Proposed new joint stock companies require a minimum share capital of CZK2m if the company is to be established without a public offer of shares, or CZK20m if the company is to be established with a public offer of shares. There is no minimum share value.

Fund vehicles

The Act on Collective Investments allows real estate investment via either real estate funds or funds of qualified investors. Real estate funds have the form of open-end funds while multiple forms of incorporation are allowed for funds of qualified investors – either as a joint-stock company, closed-end unit fund, or open-end mutual fund. Both types of funds are subject to a reduced corporate income tax rate of 5%.

These entities may become part of existing international fund structures, especially fund of qualified investors where the Parent-Subsidiary Directive may be applied on dividends paid.

Taxation

Corporate income tax – general aspects

Legal entities established in the Czech Republic, and foreign legal entities with their place of management in the Czech Republic, are taxed on both their Czech and foreign-sourced income.

The basis for computing the taxable income of a company is the difference between the company's taxable revenues and its tax-deductible costs. Tax-deductible costs generally include depreciation of buildings, structures and other assets; repairs; maintenance; real estate tax paid; real estate transfer tax paid; and other expenses incurred to generate, assure and maintain the company's taxable income. For a number of costs, it is explicitly stated in the law that they are non-deductible.

Czech tax law requires that transactions between related parties be carried out on an arm's length basis, i.e. at usual market prices. If the price of a transaction differs from the price that would be agreed between independent persons under the same or similar business conditions, and the reason for this difference cannot be satisfactorily documented, the Financial Office may challenge the contracted price and adjust the tax base by the ascertained difference. From 1 January 2006 it is possible to apply for binding transfer pricing rulings from the tax authorities.

Depreciation

With the exception of land, real estate is generally depreciable for tax purposes. Many acquisition-related expenses (such as architect's fees, lawyer's fees, notary's fees), should be capitalised as part of the cost of the relevant real estate. With regard to interest costs incurred before putting the asset into use, the taxpayer has the option to capitalise such interest costs or not.

Tax depreciation of buildings acquired through purchase may commence in the year when an application for the registration of ownership title is delivered to the Real Estate Cadastre, supposing that the ownership title is transferred and the real estate is put into use.

In the first year of depreciation, tangible assets are to be classified into one of six depreciation categories, with minimum depreciation periods ranging from 3 to 50 years. The sixth depreciation category includes hotels, 'administrative buildings' (such as office buildings), department stores and some other assets; the depreciation period for such assets put into use after 31 December 2003 is 50 years.

Generally, for newly acquired assets, the owner of the asset will determine the method of tax depreciation. Tax depreciation may be calculated using either the straight-line method or the reducing-balance method, whichever the taxpayer selects. The chosen method of depreciation cannot be changed during the depreciation period. A taxpayer has the right to stall, and then to recommence at a later time, claiming tax depreciation.

Special provisions need to be considered with respect to the tax treatment of fit-out works installed by the lessee in leased premises, in order to avoid disadvantageous tax impacts for both the lessor and the lessee, especially when lease agreements are terminated.

Withholding taxes

Dividends are subject to a 15% WHT. In the case of dividend payments to a recipient abroad, the relevant double taxation treaty may reduce this rate. The Parent-Subsidiary Directive is available to remove WHT on qualifying dividend distributions paid to shareholders in EU Member States or other qualifying Czech entities.

The dividend WHT is deducted at source and, for Czech purposes, is considered as the final tax liability. This implies that if the recipient is a Czech company or resident, they are not taxed on such dividend income.

Interest paid to non-resident recipients is subject to WHT at a rate of 15%. The rate may be reduced in accordance with the relevant double taxation treaty. As of 1 May 2004, a 0% WHT applies to qualifying interest payments, as a result of the implementation of the EU Interest-Royalties Directive.

Value added tax (VAT)

At present, it is possible for foreign companies and entrepreneurs to register in the Czech Republic for VAT only. VAT incurred in the Czech Republic can be also claimed by foreign companies and entrepreneurs through a refund procedure; however, the scope for refunding VAT to non-EU businesses is limited.

VAT is charged at two rates, the standard rate of 20%, which applies to most goods and services and the reduced rate of 10%, which in general applies to foodstuff and some other expressly listed goods and services. Currently, the Czech government is preparing an amendment that should increase the reduced rate in 2012.

The transfer of land is generally VAT-exempt; however, the sale of ‘construction land’ is liable to VAT at the rate of 20%.

The transfer of unfinished structures (including buildings, houses) and the transfer of finished structures effected within three years after (i) the first use of the real estate started, or (ii) the very first approval for use of the real estate, whichever occurs earlier, are subject to VAT at 20%. The transfer of residential buildings and the provision of construction work related to residential buildings are subject to 20% VAT; however, real estate that qualifies as ‘social housing’ is subject to the reduced 10% VAT. According to the current definition of ‘social housing’, a large portion of residential development will likely fit into this category. Accommodation services in hotels are currently subject to the 10% VAT rate.

The rent of real estate is usually VAT-exempt, but in certain situations it is possible to apply VAT on the rent. In this case the applicable rate is 20%.

If a company registered for VAT purchases a building for entrepreneurial activities, it is, in principle, entitled to claim the related input VAT. A full refund will be granted if the building is only used for activities that generate taxable supplies. However, no refund will be granted if the building is only used for exempt supplies. A partial refund will be given if the building is used partly for taxable and partly for exempt supplies. A change in the use of a building (e.g. from non-exempt to exempt activities or a change in the ratio of use between non-exempt and exempt use) in the ten years subsequent to its acquisition may have an impact on the input VAT claimed. In certain situations this may imply that part of the claimed input VAT has to be repaid.

Real estate tax

Currently, real estate tax is for most corporate owners a negligible cost despite an increase in real estate tax rates in 2010.. This tax is generally recovered from tenants via service charges.

Real estate tax consists of two taxes – land tax and a tax on buildings. Real estate tax is generally payable by the registered owner of the land or buildings. In certain cases the user or the leaseholder is the payer. The taxable period is the calendar year. The tax base is calculated according to the size (in certain cases the value) of the property as of 1 January of each calendar year. There are many different rates, depending on the purpose and the geographic location of the property. There are a number of exemptions from real estate tax. From 2012, increase of real estate tax up to CZK5/m^2 (from current CZK0.20/m^2) for reinforced plots used for business activities was implemented.

Direct investments in real estate

In some cases it may be tax beneficial for a foreign entity to structure an acquisition of Czech real estate through a branch, even if registering a branch is as administratively demanding as incorporating a Czech company. Another significant determining factor will be the exit route. Generally, the same consequences as in the case of a direct sale of real estate by a Czech legal entity will apply, the most significant proceeds being subject to real estate transfer tax of 3% and capital gains being subject to 19% CIT in the Czech Republic. If a share deal is preferred, this will likely imply that the shares in the foreign company owning the Czech branch need to be sold. This possibly reduces flexibility to a seller.

From a Czech point of view there can be scope for savings of WHT on repatriation of profits from rental of the property, and different tax treatment applies to financing in respect of the amount of interest that can reduce taxable profits. VAT issues also need to be addressed.

Buying and selling property

Capital gains and losses on the sale of property or shares

There are no separate capital gains taxes. Capital gains are considered business profits and are as such, subject to income tax. Therefore, corporate owners of real estate are subject to CIT on capital gains realised on the sale of property in the Czech Republic, at the standard CIT rate. Capital losses on the sale of real estate, except land, are generally deductible for tax purposes.

If shares in a Czech entity are sold by one foreign shareholder to another, the capital gains derived from the sale of the shares is treated as Czech-sourced income and is, therefore, subject to Czech tax, irrespective of the residency status of the seller and purchaser. In cross-border situations, however, subject to the wording of the relevant double tax treaty, the gain may be outside the scope of Czech taxation. Nevertheless, in certain double tax treaties (e.g. between the Czech Republic and France), such an exemption does not apply if the assets of the entity of which the shares are sold consist only or predominantly of immovable property.

Capital losses from the alienation of shares in a limited liability company are not tax-deductible. The same treatment applies in general to joint stock companies, although certain exceptions may apply.

Use of separate property holding companies

To avoid taxes on the disposal of the property, it is common practice to hold properties in separate special-purpose companies. Disposals are effected by selling shares in the property company.

It is important from the outset for the holding company to be located in a jurisdiction with an appropriate tax treaty and a tax system that refrains from taxing capital gains. The selection of an appropriate jurisdiction is therefore of considerable significance. A jurisdiction is less suitable if its double tax treaty with the Czech Republic treats the sale of shares in a property holding company in the same way as the disposal of the underlying property.

Czech domestic law contains a participation exemption regime with regard to capital gains from the sale of shares in a subsidiary. One of the main conditions for applying the participation exemption is a minimum holding of 10% of shares in the subsidiary for an uninterrupted period of at least 12 months. The participation exemption can be applied to the transfer of shares in a Czech subsidiary and also in a company that is a tax resident in another EU Member State, or in a third country having a double tax treaty with the Czech Republic.

Real estate transfer tax

The paid transfer of ownership title to real estate is subject to real estate transfer tax. For real estate transfer tax purposes, the term ‘real estate’ is generally interpreted according to the definition of the Czech Civil Code. The Civil Code defines real estate as plots of land and structures connected to the land by a solid foundation.

Real estate transfer tax is charged at a flat rate of 3%. The tax base is generally the sales price or the officially assessed value, whichever is higher.

Real estate transfer tax is generally paid by the seller with the purchaser acting as guarantor. In certain cases (e.g. pursuant to the execution of a court decision, in connection with bankruptcy, or composition proceedings, a public auction, etc.), the obligation to pay real estate transfer tax resides with the buyer.

Real estate transfer tax paid to the Czech tax authorities is considered as a tax-deductible cost for CIT purposes.

There are certain exemptions from real estate transfer tax, one of them being the first paid transfer of new buildings, provided that certain conditions are met. The transfer of real estate as an 'in kind' contribution into the registered capital of a company is also exempt from real estate transfer tax if certain criteria are met. This exemption only applies if the contributing party retains a share in the company for a period of at least five years, subsequent to the contribution.

The transfer of real estate as a consequence of either a merger or consolidation with another company, the transformation of a company into another legal form, or as the result of the division of a company by a demerger process is generally also exempt from real estate transfer tax.

VAT

If VAT is to be levied (*see 'Investing through a local entity'*), then generally the tax base for VAT purposes is the sales price of the real estate (excluding land). The VAT liability arises on the day on which the real estate is handed over for use, or when the decision from the Land Register is received, or when the change of ownership title is recorded in the Land Register, whichever is earlier.

Financing real estate in the Czech Republic

Debt financing

Thin capitalisation rules

With the exception of thin capitalisation and transfer pricing rules, there are no specific rules in force that limit the tax deductibility of interest on loans for the acquisition of real estate or shares. As of 1 January 2004, interest on borrowings taken up to acquire shares is generally non-deductible, unless proved otherwise. Subject to thin capitalisation rules, expensed interest is generally fully deductible, provided that financing was granted under arm's length conditions and the interest was incurred for generating taxable income.

The Czech thin capitalisation regime applicable until the end of 2007 limited the amount of tax-deductible interest costs on loans received from related parties. For thin capitalisation purposes, related parties are defined as entities that directly or indirectly participate in the management, control or capital of the recipient of the credit or loan. Participation in the control or capital means a shareholding exceeding 25% in the registered capital of the recipient of the funds borrowed.

Thin capitalisation limits are determined by the ratio of a company's borrowings to its equity. Interest on the amount of debt exceeding these ratios is non-deductible. For tax purposes, such surplus amount is considered as a dividend (unless the dividend income is paid to a tax resident in another EU country or in another country being part of the European Economic Community) and, in case of payment to a non-resident, generally liable to 15% WHT. This withholding may be reduced by relevant double taxation treaty.

. The major features of the thin capitalisation rules are as follows:

- The tax-deductibility test applies to all so-called 'financial costs on loans' (i.e. interest plus other related costs, such as bank fees).
- The debt-to-equity ratio for related-party loans to equity is 4:1.
- Financial costs paid on profit participating loans are fully tax non-deductible.

Foreign exchange differences

Unrealised foreign exchange (FX) differences on receivables and payables are for accounting purposes to be recognised and included in the profit and loss (P&L) account. Unrealised and realised FX differences are therefore treated similarly for accounting purposes. This will generally also be the case for the tax treatment.

Transfer pricing

Interest on loans provided by related parties should, as with all related party transactions, be charged at arm's length. If this condition is not met, and the difference is not properly documented, the tax authority is entitled to increase the taxpayer's tax base by the ascertained difference.

Withholding tax

Interest payments abroad are usually liable to a 15% WHT. This rate may be reduced by the applicable double taxation treaty. As of 1 May 2004, a 0% WHT applies to qualifying interest payments between related parties, as a result of the implementation of the EU Interest-Royalties Directive.

Reporting duty

In accordance with the Foreign Exchange Act and with the regulations of the Czech National Bank, Czech resident legal entities are obliged to report certain facts relating to financial credits provided by non-residents. The reporting duty is not applicable if the reported amount is lower than CZK1m.

Equity financing

Increase of registered share capital

According to the Czech Commercial Code, certain formal procedures must be undertaken to increase the registered share capital of a Czech company. These are not further commented on in this publication.

Contribution into other capital funds

Czech legislation expressly states the possibility of making monetary contributions to the equity of a limited liability company that do not form part of the registered share capital. This non-registered equity is referred to as 'other capital funds'. A contribution to the other capital funds account is administratively relatively easy, as it does not have to be registered with the Czech Commercial Register.

A contribution to other capital funds has no influence on the amount of the registered share capital. It should be also possible to repay contributions to shareholders, but only as far as losses have been covered.

A similar possibility to create other capital funds can exist in certain circumstances for joint stock companies having a single shareholder.

July 2011

Matrix

Corporate tax rate	Average annual depreciation rate for buildings	VAT on rental income; and on disposal	WHT on rental income if property is held by non-resident	Property tax on buildings	Transfer tax/stamp duty	Ownership of land by non-residents	Ownership of buildings by non-residents
Czech Republic							
19%	3.33%/2% (for 'administrative buildings')	Usually exempt, 10% or 20% in certain cases	n/a	Rates vary depending on the type and location	3%	Yes, except for agricultural land and forests in ownership of Czech state	Yes

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