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WHAT IMPLICATIONS WILL THE ABOLITION OF THE CZECH REAL ESTATE ACQUISITION TAX HAVE FOR REAL ESTATE AND CORPORATE TRANSACTIONS AND FINANCING?

Enacted in September 2020, Act No. 386/2020 Coll. abolished the Czech real estate acquisition tax with retroactive effect (dating back to ownership titles registered in December 2019). The effects that this measure will have on the local residential market are evident and have been addressed in a number of commentaries. However, the potential effects of the tax change on business transactions, whether in the wholesale real estate market or otherwise, have largely been ignored . We will take a first quick look at them in this commentary.

REAL ESTATE TRANSACTIONS

From the outset of the local real estate market, professional investors in Czech real estate have usually structured their transactions as acquisitions or sales of shares in companies that own that real estate, rather than acquisitions or sales of the real estate itself. In investor-speak, such transactions are referred to as share deals (as opposed to asset deals).

Although there were several business and legal reasons for structuring transactions in this particular way post-November 1989 (these included, for instance, restrictions imposed on the acquisition of real estate in the Czech Republic by the Foreign Exchange Act), one important factor was usually the 4% real estate transfer (later acquisition) tax levied on transactions. Interestingly enough, unlike, for instance, tax law in the Federal Republic of Germany, Czech tax law never opted to recharacterise sales of shares as *de facto* asset deals for real estate transfer or acquisition tax purposes, where the real estate was the principal asset of the company sold, even though this issue was contemplated on several occasions.

The abolition of the 4% tax on asset deals naturally gives room for considerations as to whether there are genuine reasons for changing the market practice accordingly.

So, should buyers and sellers start considering whether to abandon share deals in real estate transactions?

Key issues

- Reconsideration of the choice between a share deal and an asset deal
- Relevant in real estate and M&A transactions
- Room for an entirely new tool in secured financing

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Tax factors

From a tax perspective, the key factors that come into play when structuring transactions are not only the real estate acquisition tax, which has now been abolished, but also income tax. In the case of an asset deal, this tax liability (at the rate of 19%) is imposed on the seller's profit from the sale of the real estate (in other words, the proceeds from the sale minus the tax book value of the real estate). Conversely, in the case of a share deal, the shareholder's profit is usually completely exempt from income tax, provided that certain conditions (in particular, possession of at least a 10% share in the registered capital of the company subject to the sale for a minimum of 12 months) are met.

Therefore, an asset deal can be a realistic alternative when, for instance, the sale involves loss-making or otherwise problematic assets. Another advantage of an asset deal is that, unlike in a share deal where the historical book value of the assets does not change (is not increased) for tax depreciation purposes, the buyer can apply a tax depreciation on the entire purchase price of the assets so acquired.

This is one of the reasons why it is customary in a share deal involving certain types of transactions for the seller to have to provide a commercial discount on the purchase price to the buyer as compensation for the low tax book value and, therefore, the low tax depreciation of the company sold (investors refer to this discount as the "LCGT discount"). Therefore, from the seller's perspective, the overall saving on the transaction does not currently reach the full 19% of the difference between the market value of the real estate at sale and its tax book value, as mentioned above, but usually only half this amount. Nevertheless, the market has not yet taken a unified position on the amount of this commercial discount and, by using the asset deal structure, the parties would save themselves the costly negotiations on this issue.

Non-tax factors

In principle, share deal transactions preserve the ownership of the real estate under the same owner, regardless of the number of times the real estate is sold "indirectly" through changes of control over the company concerned. On the one hand, this may be an advantage if, for example, the sale of the real estate would trigger pre-emptive or other rights upon its transfer. Furthermore, in share deals involving income-generating property, the status of the contractual relationships (in particular the leases) is maintained, which enables the purchasers to seamlessly and smoothly take over the management of the property. On the other hand, however, this may also be a disadvantage in the sense that none of these "indirect" sales triggers the new Czech Civil Code's rules enabling parties acquiring real estate for consideration to obtain a better title than the seller actually has had if the purchaser is relying, in good faith, on the status registered in the Land Register. In addition to remedying potential problems of title, other factors in favour of asset deals are the age and the often "colourful" history of some of the companies that own the target real estate: as a result of the asset deal, the purchased assets are simply "cut off" from the rest of this corporate history.

Overall, then, the abolition of the real estate acquisition tax seems to us to be a factor that could have a significant impact on structuring transactions in the real estate market; if not by itself, then at least in those instances where the other factors predominantly point in favour the use of an asset deal structure as well.

CORPORATE TRANSACTIONS

In M&A transactions, considerations as to whether the acquisition should be structured as a share deal or an asset deal are also commonplace. Where the business or part of business sold included real estate, the 4% real estate transfer (or acquisition) tax has, thus far, usually operated as a strong factor pointing against using an asset deal. As this factor is no longer relevant, the reasons in favour of asset-deal type structures will now be all the more compelling.

In any case, in sale transactions involving a business, or any part of it, it is no longer necessary to commission an expert appraisal of the real estate itself for the purposes of the real estate acquisition tax. From now on, it will only be relevant, in transaction and bookkeeping terms, for the parties to obtain an appraisal of the business as such, and not of the real estate alone.

SECURED FINANCING

Under Czech law, security *in rem* can, in principle, be established in two ways: by mortgaging the asset or by transferring title by way of security.

So far, the 4% real estate transfer (or acquisition) tax has made the use of a security transfer much more complicated in relation to real estate. Although this tax was refundable when ownership title was transferred back from the lender to the borrower, it gave rise to certain administrative and cash-flow requirements. Upon establishing a security transfer, it was first necessary to have the real estate appraised by an expert, and to declare, and pay, tax. Upon transfer-back, it was necessary to file an additional tax return and wait for the decision of the tax authority, who would subsequently refund the tax originally paid. In cases where the security transfer had been enforced (i.e. the asset had not been returned to the borrower), no tax refund could be claimed and the tax would then constitute an additional cost of the transaction.

The abolition of this tax therefore gives rise to a new situation in which the parties to finance transactions should ask themselves whether there are relevant reasons to consider opting for a security transfer rather than a mortgage of the real estate that is to serve as collateral for the lender.

Tax factors

For income tax purposes, the borrower can continue to tax-depreciate the real estate transferred by way of security for the duration of the security transfer, under a license agreement (in Czech, *výpůjčka*) entered into with the lender as the new owner of the real estate. However, the real estate tax payable annually is always paid by the owner; therefore, this tax would be paid by the lender as an associated cost of the financing (although one can expect this cost to be contractually allocated to the borrower by contract in any case).

Non-tax factors

From a practical point of view, the choice of the security interest would very much depend on the type of the real estate and its use, and the type of parties involved. The security transfer would presumably be more feasible for real estate that is used by the borrower itself rather than to real estate that is rented out, where the finance provider would *de lege* become the lessor.

Although the enforcement of mortgages is much more flexible under the new Civil Code than it was under the previous legislation, the security transfer is a

significantly more flexible instrument than the mortgage, particularly since it allows the lender to potentially avoid enforcing the security via insolvency proceedings altogether. This is not usually possible if the security is provided in the form of a mortgage. The price for this feature of a security transfer is the cost of potential disputes regarding the value of the real estate transferred. However, if the lender is willing to take on this type of risk, the security transfer may seem as an attractive tool for avoiding the collective resolution of the borrower's insolvency – the phrase "loan-to-own" acquires its literal meaning here. Certain non-banking lenders, in particular, may find this route attractive.

SUMMARY

Overall, we believe that the abolition of the real estate acquisition tax can have significant effects, even outside the residential real estate market.

While the change will have rather marginal effects in corporate M&A transactions where the parties usually choose between the share deal and the asset deal predominantly for other reasons, the tax change may entail a more general shift from the share deal towards the asset deal in certain segments and types of transactions in the real estate market. In secured financing, the tax change may potentially give rise to a completely new product whose features can have critical implications in the event of the borrower's insolvency.

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