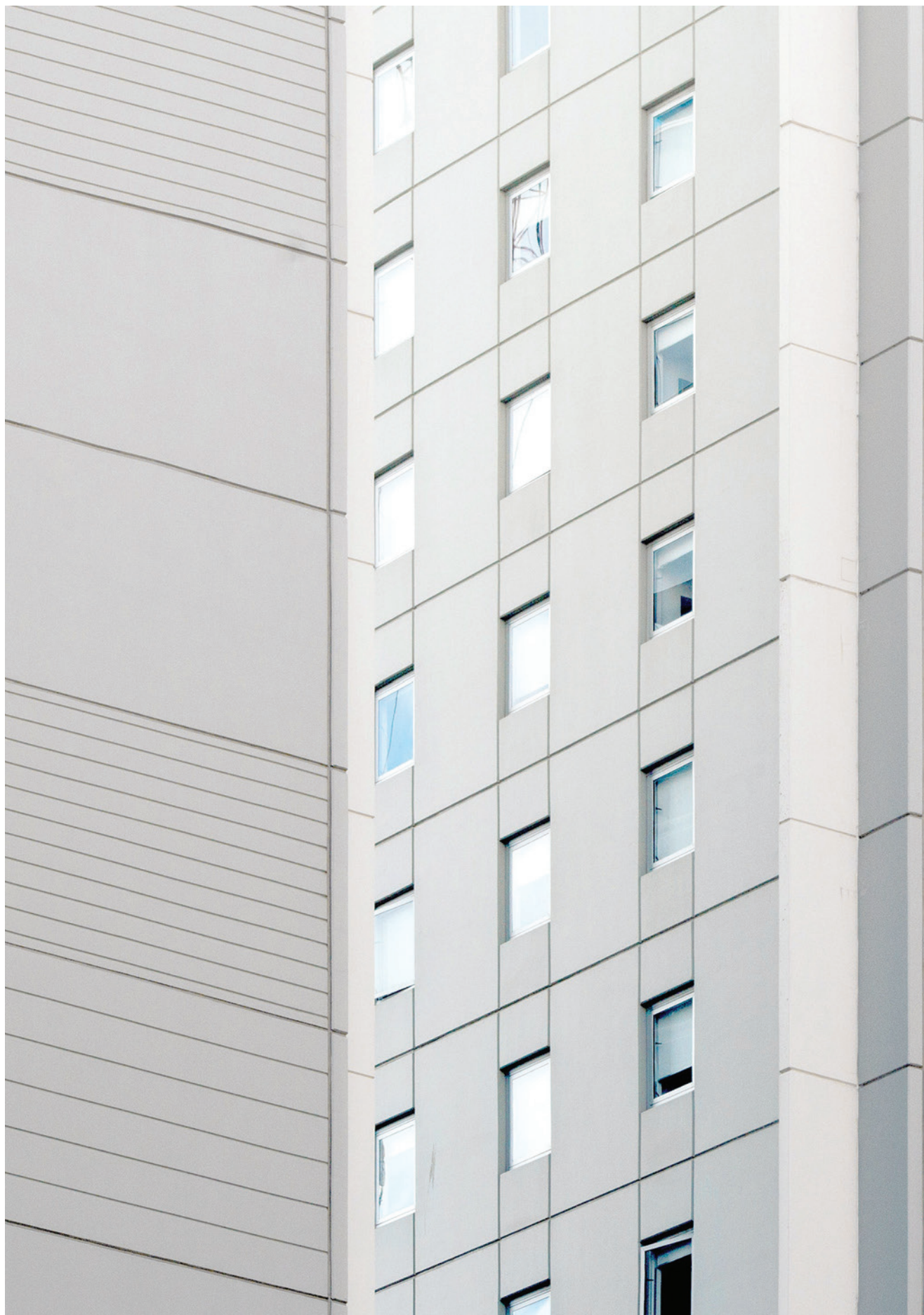




Real Estate Investment in the Czech Republic

THE LEGAL PERSPECTIVE



Introduction

The Czech real estate market is perceived to be one of the most established in the Central and Eastern European (CEE) region and continues to attract investors from various jurisdictions. The Czech economy is booming, yields are compressing and the property market is coming close to a peak.

Highly educated employees, comprehensive infrastructure, low inflation, economic and political stability and the lack of restrictions on foreigners buying properties makes the Czech Republic an attractive destination for real estate investors from all over the world.

Real estate is an important part of DLA Piper, which boasts one of the largest real estate practices in the world. We believe that legal services relating to investment in real estate should consist of more than merely helping to acquire title. In our opinion, sound investment in real estate requires knowledge of all available investment structures and their respective tax implications. This document is intended to serve as a comprehensive guide to the most relevant civil and tax law aspects of investing in real estate in the Czech Republic. We aim to use our practical experience as a valuable source of information for our readers. The guide does not claim to be exhaustive so if you have any further questions relating to the material, our experienced Czech real estate team will be happy to assist you.

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1. Ownership of real estate

1.1 Full ownership

Under Czech law, the right of full ownership over property presents the most significant right *in rem*. As a right *in rem*, the right of ownership is effective against all other persons and gives the owner of a property the full range of property rights, including the right to use, encumber or dispose of the property. However, the protection afforded by ownership may be restricted by law as the owner of a property may not seriously disturb the rights of others beyond a reasonable extent (e.g. the rights of neighbors to be protected against emissions) or perform such acts as could harm others.

The ownership of property is registered in the cadastre (*katastr nemovitostí*) which is publicly accessible and provides for the details of the owner, ownership title and rights of third persons to the relevant parcel of land, building or other structure.

Following the reform of Czech civil law in 2014, the ownership of a parcel of land comprises the space above and below the surface, buildings thereon and other facilities, except for temporary ones. However, as buildings did not form part of the parcel of land under the previously applicable law, there are a number of properties where buildings and the underlying parcels of land have different owners. In such cases, a mutual pre-emption right has been established within the civil law reform framework.

1.2 Right of construction

Based on the 2014 changes in Czech real estate law, the Czech Republic re-established the right of construction (*právo stavby*), i.e., the right to maintain a building on someone else's land (to build it or to own an existing building). The building is the property of the owner of the right of construction as this right itself is considered as real estate (*nemovitost*).

The holder of this right may erect a building on the parcel of land and build below the surface. The right of construction is only of temporary nature as it cannot last longer than 99 years.

1.3 Condominium

As in many other countries, the law in the Czech Republic provides for condominium, which is defined as coownership of a property divided into (residential or non-residential) units. Simultaneously, the unit (e.g. an apartment) itself constitutes a real estate asset. Besides the unit, its owner enjoys a share in the common area (e.g. a staircase or entrance) of the real estate jointly with other unit owners. Unless agreed otherwise, a unit owner's share is determined as a ratio of the unit's floor area to the total floor area of all units in the building.

The unit owners are members of a legal entity set up for the purpose of building administration and maintenance. For such purposes, the association of unit owners

(*společenství vlastníků*) has the capacity to acquire rights and assume duties. Membership in the association is permissible only in conjunction with the ownership of a unit and its members are liable for the debts of the association proportionally according to their share in the common areas.

1.4 Restrictions on ownership by foreigners

Generally, there are no restrictions on foreign investors acquiring real estate in the Czech Republic as the EU rules regarding the free movement of capital have applied to real estate acquisitions in the Czech Republic in full since May 1, 2011.

Neither foreigners (individuals as well as legal entities) nor legal entities domiciled in the Czech Republic which are established and controlled by non-Czech entities are subject to restrictions when acquiring real estate in the Czech Republic. The acquisition of real estate through the establishment of such legal entities is common practice in the Czech Republic.

2. Acquisition of ownership

2.1 Formal requirements

In order to be valid, any agreement for the transfer of ownership of the property must be in written form and the signatures of the parties must be on the same document (counterpart). The agreement must provide full details of the property being transferred, and either what the purchase price is or how this will be determined.

The Cadastral Act determines what type of property has to be registered in the cadastre (*katastr nemovitostí*). With exception of underground structures, small structures (in particular structures with one above-ground floor, built-up area not exceeding 16 m² and height up to 4.5 m, fences, etc.) and other special types of properties, all real estate is registered in the cadastre. To complete a transfer of ownership, the new owner must be registered in the relevant cadastre. All transfer documents are subject to review by the relevant cadastral office, which examines whether the legal requirements of the transfer have been met. In order to register a transfer of property in the cadastre, the parties' signatures must be authenticated by a notary public, local authority, attorney at law, or their authenticity proven by the applicant(s) as prescribed by the Cadastral Act. A change of ownership is effective from the date of filing the application for registration.

Data regarding some real estate is still being retrieved from registers which predate the cadastre. Such registers contain information on certain real estate whose

boundaries have not yet been fixed. However, the number of such properties is limited.

Since 2014 the reliability of the accuracy of information in the cadastre has been strengthened by the rebuttable presumption that rights registered in the cadastre have been registered in compliance with their actual legal status. Therefore, any buyer of property may rely on the contents of the cadastre and can rely upon, and is protected by, what the relevant entries say and, as long as the buyer does not have knowledge to the contrary, ownership can be acquired in good faith (bonafide: *dobrá víra*). Proper due diligence should however still be carried out.

2.2 Asset deals

The property can be acquired directly (i.e. an asset deal) by the buyer from the owner. All formal requirements referred to above must be observed in order for the asset deal to be effective.

In most cases the parties are assisted by specialist lawyers when drafting the relevant documents, negotiating the parties' agreement, financing the transaction and completing the transfer. It is highly advisable for the buyer to carry out due diligence on all aspects of the property prior to execution of a property transfer agreement. The extent of due diligence depends on the type of real estate. In-depth legal due diligence is normally carried out in relation to land since, for historical reasons, information in the cadastre may not be completely reliable. This especially applies to pre-1993 records.

Such due diligence should cover:

- all legal aspects such as title to property, easements, agreements with neighboring owners, in particular access to the property, zoning law aspects, construction law, previous contracts, lease agreements;
- particular environmental aspects; and
- the state of existing buildings and any permissible future development.

Memorandums of understanding, letters of intent, heads of terms or the like are typical documents negotiated between the parties before actual agreement on the transfer of a property under Czech law is signed. Exclusivity and confidentiality agreements, with provisions for liquidated damages in the case of breach, are valid and enforceable and are widely used.

All applications and declarations necessary to effect the transfer of property are done by the parties. Compared to other jurisdictions, notarization of the transfer document or filing of applications by a notary is not required under Czech law.

Although every buyer of a property should under take their own survey and due diligence, the seller may not withhold important information relating to the property. Under Czech law the seller of a property is obliged to disclose information to the prospective buyer on any important matter which would have a negative impact on the value of the property. It is reasonable to suppose that the buyer would

not have agreed on the purchase price if they had known about such matter. Such information may for example include construction work without an appropriate permit, public orders, issues with the tenant, technical defects, etc. Any failure by the seller to disclose this information overrides any waiver of liability that the transfer agreement may contain and may result in claims for compensation or even rescission of the transfer agreement.

Transaction costs for the transfer of property to cover registration fees, notarization of signatures etc. can be estimated up to CZK2,000 (approx. EUR75). Real estate transfer tax (see paragraph 6 below) is currently 4%. This excludes the costs of due diligence and the involvement of attorneys and technical experts.

2.3 Share deals

Another way to acquire real estate is to purchase the legal entity which owns the property (i.e. a share deal). In the Czech Republic, such a legal entity is often organized as a limited liability company (*společnost s ručením omezeným – s.r.o.*) or a joint stock company (*akciová společnost – a.s.*).

In order to transfer the shares in the property-owning company from the seller to the buyer, the parties must execute a share purchase and transfer agreement. Where the shares in a limited liability company are to be transferred, statutory law requires that signatures of the parties on the share purchase agreement are notarized or authenticated in other permitted ways. For a transfer of shares

in a joint stock company on the other hand the law does require the signatures to be notarized or authenticated.

The due diligence prior to a share deal should, in addition to the points mentioned in relation to asset deals concerning the property itself, cover the following aspects:

- all legal aspects of the shares in the company owning the property such as pre-emption rights, encumbrances etc.;
- whether the authorized share capital has been contributed completely and correctly and whether it still exists;
- annual accounts of the company;
- debt and risks; and
- whether the property company has employees and the liabilities in relation thereto.

As in many other jurisdictions, reliable shareholder registers do exist in the Czech Republic. The situation is different however in the case of joint stock companies with more than one shareholder. These companies are not obliged to register the current shareholders in the Commercial Register (*obchodní rejstřík*) and the ownership of shares in the company can be proven only by an excerpt from the shareholders list which the company itself is obliged to keep or from the Central Depository (*Centrální Depozitář*). Consequently, if the shares have been transferred several times, it is important to ascertain that there is an unbroken chain of transfer agreements (and endorsements on the share certificates with respect to joint stock companies

with registered shares) from the original shareholder to the current shareholder in order to demonstrate that the seller actually owns the shares. If the seller does not have good title to the shares, there is no statutory protection for the buyer even though it may be purchasing in good faith. This is a clear difference from an asset deal where, as previously mentioned, the seller will be assumed to be the owner of the real estate if it is registered and therefore an acquisition in good faith is possible. This demonstrates the paramount importance of a properly and duly conducted due diligence in the case of a share deal and the need to investigate potential third-party rights.

Furthermore, it is not uncommon for the company's articles of association to contain certain restrictions regarding the transfer of shares. It is common for any transferability of shares to require the prior approval of a certain majority of the existing shareholders or the existing shareholders may have rights of pre-emption.

The share purchase agreement to be entered into by the seller and the buyer must include certain mandatory aspects such as the identification of parties, the denomination of the shares which are being transferred and the purchase price. Beyond these mandatory aspects, the parties frequently agree on various other matters such as calculation methods for the purchase price, subsequent conditions, representations and warranties and remedies in the case of a breach of warranty.

The transfer of shares becomes (unless otherwise agreed in the agreement) immediately effective upon the agreement being signed. Nevertheless, a transfer of shares in a limited liability company must be subsequently registered in the Commercial Register on the basis of an appropriate application and underlying documents. As mentioned above, the registration obligation applies only to limited liability companies, and joint stock companies with a sole shareholder. Shares in a joint stock company which are certificated and registered must be properly endorsed and handed

over to the new owner, otherwise the transfer will not become effective. The managing director of a company (limited liability or joint stock company) also has a responsibility for updating the list of shareholders.

2.4 Public auctions

For specialist investors, purchasing at a public auction can be considered. Properties for sale by auction are usually the subject of an enforced sale, such as a sale pursuant to a court order or a sale where there has been default under a mortgage.

The complexity of the auction procedure makes it advisable for a prospective buyer to be accompanied by legal advisors. With thorough preparation and investigation, a portfolio of properties can be acquired at a low cost at public auction however this option usually only appeals to specialist investors.

In this context it should be added that the number of public auctions has continuously decreased in the last years as other work-out strategies are preferred by both property owners and secured lenders.



3. Other rights to property

3.1 Possession

While ownership of property is the basis for a sophisticated legal title to the property, Czech law also recognizes a special arrangement similar to the right of ownership – possession (*držba*) on the basis of which the possessor treats the property as their own although they are not technically the legal owner. However, after a certain period of time elapses (ten years continuously in the case of real estate) the possessor (if they have taken possession in good faith) becomes the owner of the property by operation of law.

3.2 Mortgages

For the purpose of securing a debt, a mortgage may be established under Czech law. Generally, the mortgage is constituted by an agreement which must identify both the amount of the debt to be secured and the property that is to be used as security. The mortgage affects the property itself as well as its constituent parts (*součástí*) and accessories (*příslušenství*). If the real estate is not registered in the cadastre (e.g. small or special structure), the mortgage agreement must be in the form of a notarial deed. The notarial deed further serves for the purpose of subsequent mortgage registration with the Register of Pledges (*Rejstřík zástav*).

In case of real estate registered in the cadastre, the mortgage becomes effective against all other persons as of the date of filing the registration with the cadastre. The time of registration may also have an impact on the rank of the mortgage if multiple mortgages are created over the same property. The rank may then significantly

affect the likelihood of the secured creditor receiving payment in the case of enforcement of the pledge (mortgage) which will occur through methods agreed between the mortgagor and mortgagee or otherwise in a public auction or a court-ordered sale of the property.

With the 2014 changes to Czech law, the negative pledge was introduced as another legal instrument to secure debts. Generally, the negative pledge prohibits the mortgagor (pledgor) from creating a mortgage (pledge). However, an instrument of negative pledge is also widely used for the prohibition of transfers and the limitation of disposals with the affected property. Also, further specific restrictions may be imposed on the mortgagor and registered in the cadastre, such as restriction not to secure a new debt by mortgage in better ranking.

The Czech civil law reform has newly enabled the parties to a mortgage agreement to agree a mortgage upon forfeiture (*propadná zástava*) where the collateral is transferred to the mortgagee for the discharge of secured debts for an arbitrary price or a price agreed in advance. However, this type of mortgage can be agreed only following the maturity of secured debts.

3.3 Easements

There are two types of easements under the Czech Civil Code.

The ordinary easement, in the Civil Code called a servitude (*služebnost*), affects the owner of property so that the owner has to tolerate or abstain from doing something in favor of someone else either

for a definite or an indefinite period of time. This right to use a property owned by someone else can be held by individual(s) or can be held *in rem*. A right *in rem* is created for the benefit of another property and all owners of that property are entitled to benefit from it. A person entitled under servitude may seek protection of their rights and this protection is guaranteed to the same extent as in the case of a right of ownership. A servitude includes everything that is required for its exercise. Such rights or easements are mostly used to create rights of way, rights to erect and maintain electrical or other supply lines, and to prevent or control development on certain land.

Real estate may be also encumbered with a real burden (*reálné břemeno*) as a result of which the temporary owner of the real estate must provide something to or do something as a debtor in favor of another person.

3.4 Pre-emption rights

A landowner can grant a pre-emption right over its property to any third party. Such a right must be registered with the cadastre in order to be valid and binding *in rem*. A pre-emption right may be created over a building erected on someone else's parcel of land and vice versa, the owner of the building enjoys a pre-emption right over the parcel of land in the event that its owner intends to sell it.

3.5 Non-registrable rights

Apart from the registrable rights mentioned above, under Czech law, anybody is free to enter into any contract with anybody else

covering a variety of obligations and rights which relate to a particular property, but which are personal in nature and not intended to be assigned or passed to other people.

In an asset deal, the rights and obligations created by such contracts, because of their personal nature, will not pass to

the buyer. Only rights registered in the cadastre are an integral part of the property and will pass to the buyer when ownership is transferred.

In share deals, however, such personal contractual rights and obligations can be inherited as the company or other entity which entered into the contract is itself

being acquired by the buyer. In this connection, it is necessary to undertake due diligence with regard to the possible existence of any such contracts or other arrangements with third parties. Appropriate representations and warranties should be included in any purchase agreement in a share deal.



4. Zoning and planning law permits

In the Czech Republic, responsibility for regulating development and the designated use of individual parcels of land largely lies with regional or municipal planning authorities. The municipal planning authority may set up a territorial plan (*územní plán*) which sets out the basic strategy for the development of the municipality, protection of its values, its layout, its landscape, and the necessary public infrastructure. The functions of the territorial plan include delimiting the developable area.

For a settled area, the municipality may also issue a regulatory plan which determines detailed conditions for the use of sites, for location and the zoning arrangement of structures, for the protection of the value and character of the area, and for the creation of a beneficial environment.

Construction and refurbishment may, in principle, only be carried out following the grant of planning permission (*územní rozhodnutí*) and subsequently of building permission (*stavební povolení*) which must comply with the territorial plan and/or regulatory plan.

Planning permission is issued as part of the zoning process. There are certain types of planning permissions, including (i) decisions as to the location of the relevant building (*rozhodnutí o umístění stavby*), (ii) decisions on subdivision and land consolidation (*rozhodnutí o dělení a slučování pozemků*), (iii) decisions regarding protection zones, and (iv) decisions or alterations to the impact of the building on the use of the area. Planning permission is valid for two years from the date it comes into force, unless the building authority decides on a longer period in a suitable case. Nevertheless, the period may not exceed five years.

In certain cases (e.g. smaller construction projects, advertising structure) planning consent (*územní souhlas*) may be issued instead of planning permission. The validity period of the planning consent is two years from the date of issuance and cannot be extended.

Building permission, on the other hand, is issued after planning permission (or planning consent) and, in the building permission the building authority lays down the

conditions for the construction of the structure and, if necessary, for its use.

Once the construction has been completed, in most cases, the designated use of a building needs to be approved by the building authority. Corresponding use permit (*kolaudační rozhodnutí*) or consent (*kolaudační souhlas*) is issued by the authority.

Any change in the use of a building, in its operational facilities (the equipment in a building necessary for its operation), in its method of construction or any substantial extension of or change in the activity carried on there, the effects of which could endanger life or public health, the life or health of animals, safety or the environment, is permitted only on the basis of an approval or a permit issued by the responsible planning authority.

5. Environmental liability

In accordance with the Czech Environment Act (*zákon o životním prostředí*), no territory may be burdened beyond an acceptable level; the limits of the acceptable level are specified by specific legal regulations.

Everyone is under an obligation to prevent pollution and protect the environment and minimize the negative effects of their activities on it. Anyone who finds out that environmental damage is imminent or actual harm to the environment has occurred is obliged to undertake all necessary measures according to their ability to prevent the imminent environmental damage or mitigate

the consequences and inform the administrative authority about these facts.

Anyone who by their conduct has caused environmental damage is required to restore the natural conditions of the environment which have been disturbed. Where environmental damage is caused, the relevant authorities may impose a fine on the person who caused the damage. Should gross damage be caused to environment, the relevant authorities may also require a cessation of the operations which have caused the damage for a period of 30 days.

For investors, it is also advisable to undertake an environmental investigation of a property prior to acquiring it. For example, where any contamination of a property renders it necessary to undertake decontamination measures, such decontamination measures may be ordered by the relevant authorities and failure to implement the required measures may lead to the imposition of a fine. In addition, the investors will take into account the fact that any decontamination measures will increase the costs of the investment.



6. Leases

Czech law differentiates between leases for commercial and/or residential premises (*nájem*) and leasehold agreements (*pacht*). Leases of commercial or residential premises are still more common than leasehold agreements which were introduced only in 2014. While a lease of commercial and/or residential premises entitles the tenant to use the leased property, the beneficiary of a leasehold agreement is entitled both to use the leased property and to benefit from it, for example, in the case of a lease of a farm that includes all farm machinery and the right to harvest crops etc. The legal differences are usually covered by regulations within the leases themselves so that regular leases and leasehold agreements can for the most part be regarded as synonymous. All issues mentioned below refer to both types of lease.

6.1 Duration

Residential leases in the Czech Republic are usually entered into either for an indefinite period of time or for a defined period of one year that is extendable several times. Commercial leases, and in particular office leases, mostly have fixed terms from five years to ten years. Since the market is tenant driven, tenants often have one or more times rights of renewal. Generally, a lease may not be entered into for a period of more than 50 years, or rather, any longer lease term would cause the lease to be considered to have been entered into for an indefinite term. In residential leases, the rules protecting tenants are stronger than in commercial leases where the parties are much freer to negotiate the conditions independently.

6.2 Rent

In commercial leases, the rent is usually calculated on the basis of a figure per m² of usable space. Usually, rent payments are due on a monthly or quarterly basis and are paid in advance. Value added tax (VAT) must be treated separately as VAT usually applies to commercial leases only. Generally, in practice commercial rents are adjusted according to the change in a certain agreed consumer price index, either the Czech national index or the European equivalent. It is standard market practice for rent increases to amount to 100% of the change in the index; however, strong tenants are usually able to cap the increase. Indexation clauses should be perfectly clear about which indexation rules apply. According to the statutory provisions, residential leases may be adjusted in line with market rent; however, only subject to certain limitations and in certain circumstances only through the court. Rent review mechanisms are not used in the Czech Republic.

6.3 Operating expenses

Under Czech law, operating expenses must be clearly separated from rent. In commercial leases, the tenant is generally obliged to pay all operating expenses relating to the property including the costs of maintaining common facilities, real estate tax and insurance. In residential leases, certain limitations apply.

6.4 Maintenance, repair and renovation at lease termination

It is the general law and standard practice that the tenant procures the day-to-day maintenance and the relevant repairs, whereas the

landlord is obliged to procure any other repairs, in particular including structural repairs and maintenance.

As regards the handover of the leased premises to the landlord as of lease termination, the leased premises should be in the original state as they were in when accepted; however, usual wear and tear during the lease is acceptable. Nevertheless, the parties are allowed to agree differently and landlords tend to push the tenants to accept reinstatement clauses. However, since the commercial lease market is tenant driven, reinstatement clauses are becoming rare.

6.5 Assignments/transfers

Assignment of the lease agreement by the tenant is generally permitted only with the consent of the landlord. Especially in commercial leases, it is standard market practice to agree certain assignment rules. It is common to allow assignment to third parties only with the prior written consent of the landlord, whereas intra-group assignments are authorized by the lease agreement itself.

6.6 Subleases

The tenant is entitled to sublease the leased property only with the prior consent of the landlord. In the case of commercial leases, it is common practice to agree that the tenant is entitled to sublease within the tenant's group or even to third parties without the need to ask for further consent. Subleasing without proper consent is considered a substantial breach of the lease agreement.

6.7 Termination

Both residential and commercial leases can be terminated immediately if either party seriously breaches its obligations under the lease, whereas the law provides for certain situations that are considered to be serious breaches, in particular a continuing failure to meet payment obligations or damaging the property in a serious way. The law provides for other termination grounds and the relevant termination period. However, in particular in commercial leases, it is common to agree on a specific termination clause adapted to the particular project and lease premises.

Generally, fixed-term leases cannot be terminated ordinarily during the lease term; however, walk-away clauses and premature termination clauses are permissible and sometimes used in connection with the payment of contractual compensation equal to the rent payable for the remainder of lease term. Nowadays, it is more common to provide shorter lease terms with automatic extension rather than a standard break option.

6.8 Sale of leased property

Generally, sale of property that is leased does not affect the lease in any way. Statutory law provides that the benefits and liabilities of

the lease are inherited by the new owner as the legal successor of the former owner and no party is entitled to terminate the lease unless agreed otherwise in the lease agreement. There is an exception in the case of unusual lease terms that do not correspond to the standard legal regulation where the acquirer is not duly informed of the situation; in such a case the relevant unusual provisions in the lease agreement do not apply. Furthermore, the acquirer may terminate the lease if it assumed in good faith that the property was not leased.



7. Tax

In this section we will summarize the main tax related aspects of real estate investment in the Czech Republic. An understanding of the Czech tax regime is crucial in determining the likely profitability of an investment and in structuring the investment to be as tax efficient as possible. As previously mentioned, the investor can structure its investment as a direct investment in Czech real estate or via a Czech holding company, and these methods differ significantly from a tax law perspective. This differentiation is relevant throughout this section. This overview follows the stages of an investment beginning with tax liability on the acquisition of real estate and finishing with the taxes due on disposal.

7.1 Transfer taxes

Real estate acquisition tax (REAT) (*daň z nabytí nemovitých věcí*), is levied on transfers of real estate located in the Czech Republic. Apart from the purchase and exchange of real estate, events which are subject to REAT also include contributions in kind (consisting of real estate) to a company.

REAT is payable by the buyer (transferee) of the real estate, the parties are not allowed to agree differently.

The first transfers of newly built family houses and apartments are exempt from real estate transfer tax.

The current REAT rate is 4% of the taxable value. The value is the higher of the purchase price and the comparative tax value. The comparative tax value can be either 75% of value of the real estate according to an expert valuation

or the value assessed by the tax authority according to the details of real estate provided. The tax payer can decrease the taxable value by the price paid for an expert valuation of the real estate in question (if required by law).

The tax return must be submitted within three months after registration of the transfer of ownership with the cadastre or within three months from the date of the transfer of ownership in the case of real estate not registered with the cadastre.

The tax is payable within the same period.

7.2 Value added tax

Currently, the Czech VAT Act recognizes three VAT rates: the standard rate of 21% and the reduced rates of 15% and 10%.

A transfer of real estate is generally subject to the standard VAT rate of 21%. An exception is available for transfers of housing for social purposes (this definition includes flats with a maximum floor area of 120 m² and family houses with a maximum floor area of 350 m²), for which a reduced rate of 15% applies.

Transfers of buildings, flats and non-residential premises are exempt from VAT after five years from the issue of the first final approval or occupancy permit. However, a taxpayer may decide to apply VAT even after the end of this period. Land other than building land is always exempt from VAT. Certain exemptions apply to transfer of land that is not intended for development.

Leases of land, buildings, flats and non-residential premises are also exempt from VAT (except for short-term leases, i.e. those which last up to 48 hours).

For VAT to apply to exempt real estate, the seller will need the prior consent of the purchaser. In these cases the reverse charge mechanism will apply – the buyer rather than the seller declares the VAT to the tax authorities and at the same time reclaims the corresponding amount as input VAT.

7.3 Other real estate taxes

Real estate owners are also required to pay real estate tax consisting of two parts – tax on land and tax on buildings or units.

Tax on land is imposed on parcels of land situated in the territory of the Czech Republic recorded in the cadastre and is payable by the person who owns, rents or uses the real estate. If the real estate is co-owned, the owners are liable for the tax jointly and severally. The annual land tax rate applicable in built-up areas, which applies to courtyards and other areas, is CZK0.20 per m². For building plots (i.e. the land that is to be used for construction), the tax rate is CZK2 per m². This basic tax rate is subject to multipliers ranging from 1.00 to 5.00 according to the number of inhabitants of the municipality where the land is located. The land is exempt to the extent by which it is built over with taxable buildings.

The tax rate for arable land, hop yards, vineyards, gardens and orchards is 0.75% of the value of the real estate. The tax rate for land used for permanent pasture,

commercial forests and ponds used for intensive fish farming is 0.25% of the value of the real estate. The value is calculated by multiplying the area of the land in m² by the value per m².

Tax on buildings or units is imposed on buildings and units situated in the territory of the Czech Republic. The tax rate on houses is CZK2 per m², on garages it is CZK8 per m², on buildings used for business activities (i.e. buildings used for some types of agriculture, industry, construction, transportation or energy infrastructure) it is CZK10, and on flats and other self-contained non-residential premises CZK2. For houses, flats and non-residential premises the basic tax rate is subject to multipliers ranging from 1.00 to 5.00 according to the number of inhabitants of the municipality.

The tax return must be filed before January 31 in the relevant year. Unless the information on the real estate owned changes and the owner had already filed the tax return in the previous year, the tax return does not need to be filed in following years. The tax is payable either in one instalment (by May 31) or in two instalments in arrears (by May 31 and November 30) if it exceeds CZK5,000.

7.4 Taxation of rental income from real estate

The taxation of rental income from real estate is different as between partnerships and corporations. When investing through a partnership, the partnership is considered to be a transparent entity and any income generated

by the partnership (for example, profit, rental income, etc.) is divided between individual partners and treated as their income. In the case of special limited partnerships, this approach applies to unlimited partners only.

If a natural person is a partner in a partnership, their share in rental income, less any tax deductible expenses (for example costs incurred in relation to the business activities, tax losses, expenses on research and development), is deemed to form part of their taxable income subject to personal income tax. Such income is taxed at a rate of 15%.

If a legal entity (corporation) is a partner in a partnership, its share in rental income, less any tax deductible expenses (for example costs incurred in relation to the business activities, tax losses, expenses on research and development), is deemed to be part of its taxable income subject to corporate income tax and is taxed at a rate of 19%.

For corporations, the rental income forms part of their taxable income which is subject to 19% corporate income tax. Also in this case costs incurred in relation to the income are generally deductible.

7.5 Taxation of dividends from a company owning real estate

In the case of an indirect investment through a partnership i.e. if an investor (an individual) has invested through a partnership in the Czech Republic, the relevant income is considered to be the part

of the partner's income which is subject to 15% tax for individuals and 19% for companies.

When investing through a company, the income of the company may be distributed in the form of dividends to its shareholders.

Dividends are generally subject to a withholding tax at a rate of 15% for both individuals and companies.

For Czech and foreign companies, the dividends are exempt if they fulfil the definition of parent-subsidiary companies (for the purposes of the EU Parent-Subsidiary directive No. 2011/96/EU (recast)). The conditions are:

- (i) both parent company (recipient) and its subsidiary (distributing entity) are EU/EFTA established companies in the form of a joint-stock company, limited liability company or cooperative (the exact list of companies eligible for exemption forms an annex to the relevant EU Directive);
- (ii) the parent company holds more than 10% of the shares in the subsidiary;
- (iii) the uninterrupted holding period is longer than one year (this condition may be fulfilled subsequently); and
- (iv) both companies are subject to corporate income tax by law.

Subject to similar conditions, the capital gains realized on the sale of a subsidiary in a non-EU/EFTA country may also be exempt, if the subsidiary is tax resident

in a country with which the Czech Republic has concluded a double taxation treaty, has a comparable legal form to that required for the standard exemption, has a relationship with its shareholder similar to parent-subsidiary definition and is subject to corporate income taxation (or similar) at rate of at least 12%.

The second option for exemption or lower taxation of dividends is application of a double taxation treaty concluded between the Czech Republic and the country which is the tax residence of the other entity. Double taxation treaties usually provide for more favorable treatment of dividend income; however, the entities need to prove that some conditions are met (e.g. tax residency, beneficial ownership of the income, holding percentage, period of holding).

Please note that for companies and individuals based in countries with which the Czech Republic has not concluded a double taxation treaty or which are not party to a bilateral or multilateral treaty on the exchange of information in relation to tax matters by which the Czech Republic is also bound, a 35% withholding tax rate may be applied to the dividends such companies receive. The same may happen to companies and individuals that are not able to prove their tax residency status.

7.6 Taxation of capital gains on real estate

Income gained from the sale of real estate is subject to income tax and, in some cases, to VAT. For more details on VAT, please refer to the relevant section above.

In general, the income of an individual arising from the sale of real estate is subject to 15% personal income tax. The income may be decreased by the former acquisition value of the real estate (or the tax residual value if depreciated).

Czech tax law stipulates certain exemptions from liability for personal income tax, for example, if the seller used the real estate for their residence for at least two years prior to the sale and the gain is intended to be used to purchase another house/apartment as their residence, otherwise the period between the real estate acquisition and its sale must exceed five years. No exemption is available for real estate being part of the individual's business assets.

For companies, the capital gains from real estate are subject to 19% corporate income tax and the taxpayer may decrease the taxable amount by the tax residual value or acquisition value if the real estate could not be depreciated.

The income from real estate located in the Czech Republic is deemed to be Czech-sourced income and, therefore, also foreign individuals and entities are required to tax the income in the Czech Republic. Double taxation treaties generally include similar provisions.

7.7 Taxation of capital gains from the disposal of shares in a company owning real estate

In general, Czech law does not recognize any special rules regarding the taxation of capital gains from disposal of shares in a company owning real estate.

On the other hand, some of the double taxation treaties concluded by the Czech Republic allow that, contrary to standard rule (i.e. taxation in the country of tax residency), the gains from a disposal of shares in a company owning real estate located in the Czech Republic may also be taxed in the Czech Republic.

To go back to local rules, the capital gains are taxed as follows:

For individuals, gains are taxed at 15% forming a separate partial tax base. The income is exempt if the share holding period exceeds three years for joint-stock companies and holding period for the ownership interest is longer than five years for limited liability companies. The shares or ownership interests cannot form part of the business assets of an individual to be eligible for the exemption.

For companies, capital gains from a transfer of shares in a Czech established subsidiary realized by a Czech/EU/EFTA parent company may be exempt from corporate income tax if the following conditions are met:

- (i) both parent company (recipient) and its subsidiary (distributing entity) are EU/EFTA established companies with the form of a joint-stock company, limited liability company or cooperative (the exact list of companies eligible for exemption forms an annex to the respective EU Directive);
- (ii) the parent company holds more than 10% of the shares in the subsidiary;

(iii) the uninterrupted holding period is longer than one year (this condition may be fulfilled subsequently); and

(iv) both companies are subject to corporate income tax by law.

Subject to similar conditions, the capital gains realized on the sale of a subsidiary in non-EU/ EFTA country may also be exempt, if the subsidiary is tax resident in a country with which the Czech Republic has concluded a double taxation treaty, has a comparable legal form to that required for the standard exemption, has a relationship with its shareholder similar to parent-subsidiary definition and is subject to corporate income taxation (or similar) at rate of at least 12%.

There are no special local rules in respect of taxation of a gain on a disposal of a partnership interest in a partnership owning real estate.

The gain is taxed as income of the unlimited partner at 15% (for individuals) or 19% (for companies).

7.8 Real estate investment trusts

Czech trusts (*svěřenské fondy*) are a new vehicle for owning real estate as of January 1, 2014. A contribution of real estate to the trust has similar consequences as such contributions to a company. For the trust, the contribution itself does not represent any taxable income. If no consideration is received for the contribution, it is not subject to real estate acquisition tax.

Operations with the assets of the trust are subject to standard corporate taxation at 19% and the trust also pays real estate tax.

The pay-out of gains to trustees is subject to 15% withholding tax. Such amounts are subject to the same tax regime as other profit distributions to foreigners, i.e. these can either use double taxation treaty protection to achieve exemption or lower taxation. Double taxation treaties usually provide for more favorable treatment of profit; however, the recipients need to prove that some conditions are met (e.g. tax residency, beneficial ownership of the income, holding percentage, period of holding).

For recipients based in countries with which the Czech Republic has not concluded a double taxation treaty or which are not a party to a bilateral or multilateral treaty on the exchange of information in the tax matters by which the Czech Republic is also bound, a 35% withholding tax rate may apply to dividends received. The same may happen to companies and individuals that are not able to prove their tax residency status.

The taxation of foreign trusts is unclear. Where it is proved that the foreign trust is comparable to a Czech one, the same rules apply.

7.9 Real estate funds

Investors may be interested in investing through special funds. These funds may give an investor an advantage in the form of a 5% corporate income tax rate. To achieve this favorable tax rate, one of the following criteria needs to be met:

- (i) the securities of the fund are traded on European regulated market;
- (ii) the fund is an open-ended fund; and
- (iii) investment fund has invested more than 90% of the value of its investments to other assets than real estate.

Otherwise, the fund is subject to a standard 19% corporate income tax.

The gain from securities is subject to a standard 15% tax rate for individuals and a 19 % tax rate for companies. An exemption of such income is available for individuals, if the holding period exceeds three years.



8. Real estate finance

Real estate finance involves financing or refinancing the acquisition and/or development of property where the principal debt is generally secured by the capital value of the property and the debt is serviced from the income generated by the occupation of the property. It is highly advisable to carry out due diligence covering the financial issues prior to taking an investment decision. Such due diligence should cover:

- market and location analysis;
- a review of profitability;
- tenant analysis; and
- recoverable and non-recoverable costs.

The final evaluation should be available by the stage of the credit decision at the very latest.

8.1 Interest rate risks

Commercial property financing is possible with long-term and short-term loans. In both cases there is a risk of rising interest-rates. An important protection here is the use of fixed interest for certain periods. However, the risk of interest rate fluctuation still exists when the loan is extended or on the conclusion of follow-up financing. This can be hedged against by derivatives, particularly interest rate swaps.

The most common type of interest rate swap is a Plain Vanilla Swap. It is available through the lending institution itself or a third-party financial institution. Within the scope of the Plain Vanilla Swap the borrower agrees to pay a fixed rate to the counterparty, while receiving a floating rate indexed to a reference rate

(i.e. three-month EURIBOR).

With the money received by the counterparty the floating loan interest is paid to the lending institution. In this way the borrower eliminates the risk of rising interest-rates. Concurrently, the advantage of sinking interest-rates is given up and now lies with the counterparty.

8.2 Assets held as security

Loan agreements with financial institutions that specialize in property financing need to be balanced between the interests of the parties involved. In order to assure this, financing is usually granted against land collateral.

The usual land collateral is a mortgage in the form of a security right with an accessory nature. In order to be valid such a mortgage must be registered in the cadastre. Due to the accessory nature of the mortgage, the validity of the mortgage is conditional upon the existence of the underlying secured claim and cannot be assigned to a third party without such underlying claim.

8.3 Further collateral agreements

In the context of the financing and refinancing of property, further agreements and means of collateral are of importance.

8.3.1 Share/interest pledge agreement

Share and interest pledges can also be used as collateral for loan claims. For the pledge of shares in a limited liability company and joint stock company the same requirements apply as with the formalities of the agreement. Notarization of the

agreement is not required. It is important to check that share/interest pledges are not prohibited by the articles of association of the respective company. In addition, the articles of association of a company may provide for a requirement for an approval by the general meeting.

A pledge over shares in a limited liability company becomes effective only upon registration of the pledge in the Commercial Register. As with a transfer of certificated shares in a joint stock company, a pledge over such shares requires the endorsement of the shares and a hand over to the pledgee (or a third party authorized by the pledgee).

8.3.2 Assignment or pledge of lease receivables

Typically also lease receivables, meaning all present and future, conditional and unconditional claims, rights, title and interests under and in connection with the relevant lease agreements (including, but not limited to, any claims for the payment of rent) are assigned as security or pledged to the lending institution. The prerequisite is the determinability of the individual claims. A notification to the tenants is required for the perfection of security.

8.3.3 Bank account pledge agreement

Bank account pledges as collateral are possible over bank accounts run by the lending institution itself (lending bank) or a third party (account bank), in particular the operating accounts. The existence of the account pledge depends upon the existence of the

underlying secured claim and can only be assigned together with it. A notification to the account bank is required for the perfection of the security. It should also be noted, that the account bank usually has a first ranking pledge under its general terms of business. A waiver/subordination is needed, if the lending bank wants a first ranking security. The right of the pledgor to retain access to the pledged accounts can be stated in the account pledge agreement.

8.3.4 Duty of care agreement

Lending institutions have reasonable interest in the preservation of the value of the property not only because it is used as land collateral, but also because it provides the required income for the owner under lease agreements in order to be in a position to service the loan. Against this background, usually a duty of care agreement to which a foreign system of law applies is concluded as a measure of providing extra security. Where

the real property is rented out and managed by an agent, the lending institution has little control over the day-to-day operation. The property manager only owes a duty of care to the property owner under the management agreement. With a duty of care agreement the duty is extended to the lending institution. Typically the property manager is also obliged to provide the lending institution with documents and information related to the property upon reasonable request.



Glossary

TERM	EQUIVALENT
Katastr nemovitostí	Cadastre
Předkupní právo	Pre-emption right
Právo stavby	Right of construction
Nemovitost	Property or real estate
Stavební pozemek	Building plot
Jednotka	Unit
Spoluvlastnictví	Co-ownership
Společenství vlastníků jednotek	Association of unit owners
Společnost s ručením omezeným	Limited liability company
Akciová společnost	Joint stock company
Obchodní rejstřík	Commercial register
Centrální depozitář	Central depository
Držba	Possession
Dobrá víra	Good faith
Zástavní právo k nemovitosti	Mortgage
Zástavní právo	Pledge
Propadná zástava	Forfeiture
Služebnost	Servitude
Reálné břemeno	Real burden
Příslušenství	Accessories
Věcné břemeno	Easement
Zákon o životním prostředí	Czech environment act
Katastrální zákon	Cadastral Act
Nájem	Lease
Pacht	Leasehold
Postoupení	Assignment
Daň z nabytí nemovitých věcí	Real estate transfer tax

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About DLA Piper

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team's global resources, regional strength and local delivery, and include private and public companies, institutional investors and government entities.

In the Czech Republic, we have a large team of lawyers in Prague with years of experience in the local real estate industry. They advise on

issues affecting all stages of the real estate investment and development cycle and work with a large number of Czech and international clients. Our lawyers are also active members of and contributors to the business communities and industry associations that have a key role in shaping the future of the Czech real estate industry.

This guide was written predominantly by Zuzana Slovakova and Marek Stradal of our Real Estate practice group.

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