

Taxation of Investment Apartments and Dwelling Houses

Abstract: The article deals with the property taxation of investment apartments and dwelling houses. This paper's main aim is to verify the hypothesis that to increase tax on investment apartments and investment dwelling houses, it is necessary to amend the Immovable Property Tax Act. To confirm or disprove the hypothesis, the investment property was defined as the second home if used for long-term or short-term rent or not used at all. The article briefly focuses on other taxes connected with the acquisition of immovable property, analyses de lege lata regulation of recurrent property tax on investment apartments and investment dwelling houses in the Czech Republic, and briefly introduces two main systems of property taxation (based on values and area). The hypothesis was disproved. If the property is used as the first home, the taxation is, in line with the policy at the national and local level, lower. These rules apply to the property, both taxpayer-owned and long-term rented, as the criteria are the usage of the property. Concerning the dwelling houses and apartments used for short-term rents (typically Airbnb type of accommodation) or other businesses, they should be taxed at a higher rate. However, the tax administration must strictly follow the legal text as the crucial for taxation is how the property is actually used. It is also necessary to check the periodicity of the contracts and who the tenants are, the service provided for the guests, the purpose of accommodation, who is responsible for routine maintenance and minor repairs, etc.

Keywords: tax, property tax, tax on immovable property, investment apartment, investment dwelling houses

Introduction

During and after the Covid-19 crises, we can see that the inflation in many countries is rising. One of the tools how to protect the value of money is property investment. As many investors believe in this solution, demand for flats or other properties has significantly exceeded supply, the property prices are rising, and so does mortgage rates. For many families, it is impossible to buy their own house or flat because of their low incomes and high market values. The number of social apartments owned

by the municipalities is not adequate to the demand. Many politicians, not only in the Czech Republic, believe that the way how to solve the housing crisis and discourage investors from buying properties not to be used for living and to lower the market prices is to set a higher tax on investment properties, namely dwelling (family) houses and flats. For this purpose, they want to amend the Immovable Property Tax Act (Act No. 338/1992 Sb., on Tax on Immovable Property, as amended). At this place, it must be stated that the property tax generally in the Czech Republic is one of the lowest in the world [Radvan, Franzsen, McCluskey, Plimmer 2021, pp. 1081–1082].

This paper's main aim is to verify the hypothesis that to increase tax on investment apartments and investment dwelling houses, it is necessary to amend the Immovable Property Tax Act. To confirm or disprove the hypothesis, it will be necessary to define investment property. As there might be other taxes connected with the acquisition of immovable property, we will briefly focus on these issues. We will focus on the analyses of *de lege lata* regulation of recurrent property tax on investment apartments and investment dwelling houses in the Czech Republic. Additionally, we will briefly introduce two main systems of property taxation (based on values and area) so that we can confirm or disprove thy hypothesis and offer solutions *de lege ferenda* in the area of our research.

To reach the aim of our contribution, the classical research methods and techniques developed within the framework of legal sciences were used. An important value of legal knowledge is determining the meaning of norms (rules of behavior) contained in the legislation. Therefore, the formal dogmatic method was used as a primal method. To analyze, interpret and assess the existing tax legislation, it was necessary to apply the rules of legal linguistic interpretation. Later on, it was possible to describe and systemize tax law provisions applicable to the investment dwelling houses and investment apartments taxation. Partially, the comparative method was used to compare the legal regulation of individual property types' taxation. The synthesis of arguments allowed to formulate the conclusions, confirm or disprove the hypothesis, and possibly offer improvements for the *de lege ferenda* regulation.

This research is innovative and original. There are no books, scientific articles, or conference proceedings contributions dealing with the investment dwelling houses and investment apartments taxation issues in the Czech Republic.

Investment Property

It could be said that at the moment, the big trend is to acquire another property for subsequent investment. First, it is necessary to define the term investment property (investment dwelling houses and investment apartments) as this term is not defined by law.

We have decided to create two groups of properties used for housing. The first home is a family house or an apartment used for primary housing. The second home is a cottage, a weekend house, and also the second family house or the second apartment. The second home might be used for recreation or housing if the owner or user works at one municipality and works in another. In all these cases, we do not consider the second home an investment property. However, if the second home is used for long-term or short-term rent or not used at all (the owner speculates on price increases), we consider it the investment property. The investment property is used solely for investment purposes.

Taxes Connected with the Acquisition of Immovable Property

Generally, there are tax transaction costs associated with the acquisition of investment property. The most important is usually the property transfer tax. However, in the Czech Republic, the tax on the acquisition of immovable property was abolished on 26 September 2020.

Property transfer tax was originally paid by the seller, while the buyer was the surety. Adopting the tax on acquisition of immovable property effective since 1 January 2014, the taxpayer was still the seller, even if the tax title included the word “acquisition” and the object was defined as the acquisition of immovable property. The object of taxation was an acquisition of property right on immovable property (land, structure/building, unit (flat, non-residential premise), the right of construction burdening the land, and shares on the immovable property) located in the territory of the Czech Republic for consideration.

Generally, the tax base was the acquisition value reduced by the eligible expenses (costs of the expert’s report). It was necessary to compare the contract price and 75 % of the comparative tax value to get the acquisition value. The comparative tax value might have been the indicative value self-assessed by the taxpayer using the bylaw or the price determined by an expert. In the Czech Republic, the tax rate was linear at 4%.

One of the reasons mentioned in the explanatory report to the Act abolishing the tax on the acquisition of immovable property was that the abolition deals with the effects of Covid-19 on society. It is really important to discuss whether the abolition of the tax was the cause of the Covid-19 (economic) crises or simply a political move before the elections. Moreover, there are impacts on the state budget. And as the abolition of the tax on acquisition of immovable property is retroactive (if the cadastre deposit has been made in December 2019 and later), the taxpayers who have already filed their tax returns and paid the tax may ask the tax office to send the paid tax back.

In our opinion, abolishing the tax on the acquisition of immovable property was not a wrong move. Many families may be more motivated by this cancellation to pur-

chase real estate; however, it also stimulates the demand. The less administrative burden could also be an advantage. Then the question remains whether the cancellation should not have come earlier or later. Given the current Covid-19 crisis and the burden on the state budget, the decision could end up being more of a negative than a positive move.

In the context of any change in the ownership of immovable property, an entry in the register of immovable property (the cadastre) must be made, including the amendment or cessation of those rights. From 1 January 2020, fees for a land registry deposit doubled from the original 1,000 CZK to 2,000 CZK. The fee increase relates to deposit proposals submitted from 1 January 2020.

Legal Regulation de Lege Lata

Czech Immovable Property Tax Act provides for two taxes on immovable property: the land tax and the tax on structures and units, including houses, flats/apartments, and non-residential premises (non-dwelling units). Primarily, the unit/area-based system (in terms of square meters) is used. Only in the case of agricultural land is the ad valorem system partially used (the land area is multiplied by the local coefficient to provide the average price per square meter of the land as laid down by decree issued by the Ministry of Agriculture).

For the structures and units, the area-based system is used. As many factors might influence the tax rate structure, it is possible to state that the modified area-based system is being used. The following text deals only with houses and flats used for dwelling. It will be focused on family houses, summer houses (cottages), and dwelling units (flats/apartments).

Generally, the taxpayer for the immovable property tax is the owner of the property. The objects of taxation are buildings connected to the land with fixed foundations. Concerning units, only flats registered in the cadastre are liable to the tax. Apartment block buildings, in respect of which the tax is payable on the individual apartments/flats, are not liable to the building tax. There are several reasons and many conditions under which property may be exempt from taxation. The most common condition is where the property is not used for profit-making purposes. In several cases, a tax return does not have to be even filed. The exemptions can be categorized into permanent or temporary exemptions. From the perspective of this contribution, there is an exemption for dwelling houses, apartments, and buildings for family recreation owned by disabled persons. Besides the exemptions set directly in the act, municipalities may grant temporary exemptions for buildings affected by a natural disaster and for buildings in special industrial zones.

The basis of the tax is the same for all buildings and is defined as the built-up area (in square meters) as of 1 January of the taxable period. In the case of apartments,

the tax base is the adjusted floor area, which refers to the total floor area of the flat or non-residential property in square meters as of 1 January of the taxable period, multiplied by a coefficient of 1.20 (or 1.22, if there is any land used together with the unit).

The main difference between analyzed property types' taxation lies in rates. The standard tax rate for dwelling houses and for flats is 2 CZK per square meter of built-on area. In the case of dwelling houses, this rate is increased by 0.75 CZK per each additional floor above ground level. This standard or increased rate is multiplied by the location rent (btw. 1.0 – 5.0 depending on the number of inhabitants; the municipality can increase or reduce the basic coefficient set in the act by a generally binding ordinance). The standard tax rate for houses and family houses used for family recreation (summer cottages) is 6 CZK per square meter of the built-on area. This rate is increased by a tax rate of 0.75 CZK for each additional floor above ground level and by the so-called municipal coefficient (1.5; assessed by a generally binding ordinance issued by the municipality). If such houses are located in national parks or first-category protected countryside zones, an additional coefficient of 2.0 is applied. The standard tax rate for houses and flats used for business activities depends on the type of business activity; if used for accommodation, it is 10 CZK per square meter of the built-on land area. The standard tax rate is increased by an additional tax rate (0.75 CZK per each additional floor above ground level for houses) and by the municipal coefficient (1.5).

For all the above-mentioned types of property, the municipality may, by generally binding ordinance, set the local coefficient at a level between 1.1 and 5, whereby the coefficient must be set to one decimal place. This coefficient is multiplying the property tax. The coefficient can be set either for all immovable property in the territory of the entire municipality or for all immovable property in the territory of an individual part of the municipality. It is, therefore, necessary to beware of possible conflicts with the standards governing public aid. The fundamental shortcoming is the impossibility of applying the local coefficient only to individual types of land, buildings, or units or setting different local coefficient levels for different types of land, buildings, and units. According to the *de lege lata* situation, many officials fear losing voters by increasing the property tax. They would welcome the option of not applying the local coefficient to residential buildings and apartments, as well as the option of introducing a local coefficient for, for example, only buildings used for business activities and for recreational buildings, i.e., in those cases where they would not need to overtax local residents.

Obviously, the classification of immovable property for tax purposes has nothing to do with the classification mentioned above in chapter 2. Dwelling houses and apartments may be used as the first home or the second home or be rented on a long-term basis but still taxed at the lowest tax rates. The lowest rate is to be used even if the property is unused. Houses and family houses used for family recreation are the typical second homes. Short-term rents of immovable properties are to be taxed at a

higher rate. However, in practice, the taxpayers believe that the tax office is unaware of these short-term rentals. Some taxpayers even do not know that they are running a business with short-term rentals and are liable to income tax. These are the reasons why the investment apartments and houses are, in practice, taxed in the same way as any other apartment or dwelling house.

Possible Solutions de Lege Ferenda

According to the most respected author in the field of property tax legal regulation [Youngman 2016, Franzsen, McCluskey 2017, Radvan, Franzsen, McCluskey, Plimmer 2021], there are two basic models how to annually tax property: a value-based system and an area-based system. Both models allow specific modifications to reach the economic and political aims.

Value-Based Taxation

A value-based system of property taxation is possible if regular re-evaluations are introduced and the tax value is determined as close to the asset's real value as possible. However, this has proved to be a problem in many countries that have opted for ad valorem taxation. Such a system must be viewed from two sides, both by the taxpayer and by the tax authority – the State. Like any change, there would be upsides and downsides to any change to the value system.

The very existence of real estate taxation is absolutely necessary and tax-equitable. The Czech Republic has long had some of the lowest real estate tax revenues in the entire European Union. I see one of the main problems with the transition to ad valorem taxation in the established tax base. Despite the fact that the Czech Republic is trying to move to a value-based method for its determination in the case of soil, no change is yet planned in the area of buildings. In the case of land, each year, its creditworthiness is determined by the relevant decree of the Ministry of Agriculture for each land registry.

As the percentage linear rate of tax is determined to calculate the tax instead of the fixed rate in the case of buildings, we see some issues in the transition. The tax base should always be determined by the value of the assets identified from the contracts that form an annex to, for example, a land registry deposit. If the amount could not be ascertained, it would be determined by the price of similar properties in the locality. The transition to ad valorem taxation itself, regardless of the fact that it would currently be more favorable, is far from simple, especially for the divergence between Czech and European legal regulation, which differs significantly in many ways.

The value-based system of taxation of immovable property currently has a significant presence and is worldwide. Such a system is, for example, common to the

US. Efforts to choose an ad valorem system were already made within the Czech Republic in 2012. The draft law, drafted by the Ministry of Finance of the Czech Republic, provided for ad valorem taxation only for land in areas that are or could be built up [Radvan 2012].

Whether or not the transition to the ad valorem method occurs in the future, it will entail a significant proportion of administrative changes and some burdens, including administrative cost increases. However, in the long term, the method of value taxation is certainly fairer and more revenue-friendly. If such a transition occurs, it should mean benefits in the first place. I consider it absolutely important for the value-based system to choose the correct method of valuation of real estate [Radvan 2012].

Modified Area-Based System

As evident from the international literature sum up in Franzsen's presentation [2016], the area-based system is used primarily in developing countries, in Europe, especially in Central and Eastern European Countries. In the case of buildings and apartments, it might be based on the built-up area or carpet (habitable) area. Most countries modify the original area-based system according to their economic and political needs or with regard to the regulation in related legal areas. E.g., the Czech tax base for apartments is the adjusted floor area, which covers not only the total floor area of the flat but the related common areas of the house and land related to the house. Most of the modifications in the Czech property tax regulation are hidden in the tax rate structure. E.g., the location rent following the number of inhabitants (at least partially) reflects the value as the property situated in big cities usually has a higher value than the property in the rural area. The business property generally has a higher value than the residential property, so the basic tax rate is higher for houses and apartments used for business.

The area-based system, especially if modified reasonably, might be a perfect solution for countries where the political will to substantially increase the property tax is missing. This system is pretty cheap, especially if the cadaster (property register) is complete and accurate. Having direct access to the cadaster, the tax office can assess the tax without asking the taxpayer to file the tax return. Only in case of uncertainty, there must be a possibility to make the situation clear: the tax office may use online tools (geographic maps, online maps, street view, etc., or contact the taxpayer).

Conclusion

Unfortunately, in the Czech Republic, there is no political will to increase the re-current property tax. That is why it is better to stick to using the area-based system of

property taxation. Dealing specifically with the investment apartments and dwelling houses, there is almost no need to change the legal regulation to tax them properly. If the property is used as the first home, the taxation is, in line with the policy at the national and local level, lower. As well the second homes (second house or apartment if the taxpayer works in another city, houses and family houses used for family recreation) might be taxed in an existing way. These rules apply to the property, both taxpayer-owned and long-term rented, as the criteria are the usage of the property.

Concerning the dwelling houses and apartments used for short-term rents (typically Airbnb type of accommodation) or other businesses, they should be taxed at a higher rate. To define the short time, it is formally possible to use the period of sixty days as defined for the local charge on stay. However, the tax administration must strictly follow the legal text as the crucial for taxation is how the property is actually used. To decide if the rent is long-term or short term (i.e., it is a business), it is also necessary to check the periodicity of the contracts and who are the tenants (more guests for a short time evokes the business), what is the service provided for the guests (breakfast, cleaning, linen change, soap, towels, toilet paper, etc. looks like business), what is the purpose of accommodation (providing housing needs or recreation), who is responsible for routine maintenance and minor repairs, etc. To sum up, the tax office should investigate what type of contract *de facto* is concluded. Tax officials may use advertisement screenings, they may interview witnesses, perform local investigations, check the Airbnb web pages, etc. [Radvan, Kolářová 2020]. This approach was confirmed in several decisions of the Court of Justice of the European Union dealing with the definition of rent (C-326/99 *Goed Wonen*, C-409/98 *Mirror Group*, C-346/95 *Blasi*, etc.) and Czech courts (Municipal Court in Prague: 6 Af 20/2020–28).

The hypothesis stated in the introduction was disproved: to increase tax on investment apartments and investment dwelling houses, it is not necessary to amend the *Immovable Property Tax Act*. The condition *sine qua non* to follow the legal rules is the proper functioning of tax administration.

However, the discussion about the recurrent property tax with connection to the investment dwelling houses and apartments has not finished yet. As stated above, many politicians not only in the Czech Republic believe that higher property tax on an investment property may solve the housing crises. There are several examples proving that such a solution does not lead to the desired result. E.g., in Vancouver, the higher taxation of investment property has brought additional money to the local budget but has not affected the market at all [Štuková 2021]. Many cities worldwide tend to have higher property taxes on empty apartments (e.g., Los Angeles, Hong Kong [Štuková 2021]). This is not the case in the Czech Republic, as the number of actually long-term empty apartments is extremely low. That is why it is unnecessary to deal with any specific (higher) taxation of empty (unused) apartments or dwelling houses.

The property tax in the Czech Republic must be amended generally and not with regard to the investment property only. The most important issue is extremely low property tax revenue. A very easy step might be the amendment of the local coefficient. It is helpful that from 2021 the coefficient can be set either for all immovable property in the territory of the entire municipality or for all immovable property in the territory of an individual part of the municipality. However, it is still impossible to apply the local coefficient only to individual types of land, buildings, or units or set different local coefficient levels for different types of land, buildings, and units. As well from the perspectives of investment property, it would be useful if there is an option to introduce a local coefficient for only buildings used for business activities (i.e., investment property, too) or for recreational buildings. Such a solution would not affect local residents – local voters. Yes, property tax is a politicum.

The long-term solution for the Czech property tax is a system similar to local charges: the tax should be much more influenced by the municipalities, but it should be obligatory local tax. The area-based system should be retained. There should be one maximum tax rate in the legislation for every type of property. Municipalities should have the right to introduce their own specific tax rates below that level. As there are more than 6,250 municipalities in the Czech Republic, and many of them are extremely small with a very low number of inhabitants, there should be another rate (standard rate) in the legislation for those municipalities that do not set their own specific tax rates [Radvan, Kranecová 2021, p. 76].

Bibliography

- Franzsen R. (2016), *Features of Ad Valorem Property Tax Systems – International Comparisons I (presentation)* [in:] *Market Value-Based Taxation of Real Property: Lessons from International Experience*, CEF and Lincoln Institute of Land Policy, Ljubljana.
- Franzsen R., McCluskey W. (2017), *Property Tax in Africa – Status, Challenges, and Prospects*. Lincoln Institute of Land Policy, Lincoln Institute of Land Policy, Cambridge, www.lincolninst.edu, access as of 17 September 2021.
- Juchniewicz E., Sowiński T., Radvan M. (eds.), *The Financial Law towards Challenges of the XXI Century: Conference Proceedings*, Masaryk University, Brno.
- Kvapilová V. (2021), *Immovable Property Taxation Reforms (MA thesis)*, Masaryk University, Brno.
- Radvan M. (2012), *Místní daně (Local Taxes)*, Wolters Kluwer, Prague.
- Radvan M., Franzsen R., McCluskey W. J., Plimmer F. (2021), *Real Property Taxes and Property Markets in CEE Countries and Central Asia*, Lex Localis – Institute for Local Self-Government, Maribor, www.lex.localis.press, access as of 17 September 2021.
- Radvan M., Kolářová Z. (2020), *Airbnb Taxation* [in:] Mrkývka P., Gliniecka J., Tomášková Radvan M., Kranecová J. (2021), *Is Ad valorem Property Taxation a Solution for the Czech Republic* [in:] Radvan M., Franzsen R., McCluskey W. J., Plimmer F., *Real Property Taxes and Property Markets in CEE Countries and Central Asia*, Lex Localis – Institute for Local Self Government, Maribor, www.lex-localis.press/index.php, access as of 17 September 2021.

Štuková K. (2021), *Zkrotí ceny nemovitostí daň na druhé a další byty? Jedno město už ví* (*Will the Tax on Second and Additional Flats Tame Property Prices? One City Already Knows*), www.seznamzpravy.cz, access as of 17 September 2021.

Youngman J. M. (2016), *A Good Tax*, Lincoln Institute of Land Policy, Cambridge.