

Application of VAT on the supply of plots of land in 2014

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The current provisions of Sec. 56 of the VAT Act¹ are not in some aspects in accordance with the Directive². I refer in particular to the tax regime concerning the transfer of land under buildings and most likely the same applies to a very narrowly defined number of building sites. With respect to the new Civil Code³, amendment no. 56 was prepared as a part of the "re-codification" tax package, which was very similar to the European concept but was rejected by the Senate. We can assume that it will be reintroduced as a legal measure. I would like to inform you about certain issues we will have to tackle in the next year.

1. Plots of land in the Directive and in the case law of the European Court of Justice

The Directive divides plots of land into three categories:

- III **building land**, described by article 12 sec. 3 as any unimproved or improved land which is defined as building land by the Member States and whose supply is always a taxable supply [article 135 sec. 1(k)];
- III **land which has not been built on other than a building land** and which supply is tax exempt with no input tax deductibility [article 135 sec. 1(k)]; and
- III **land adjoining a building** (most of the language versions of the Directive describe the land on which a building stands), whereas the tax regime at the moment of its supply is the same as the tax regime of the supply of the building which is on it [taxable or exempt supply in accordance with article 135 sec. 1(j)].

The above-mentioned provisions immediately suggest that such brief wording will not suffice for the practical application of VAT. In respect of the suggested wording of the amendment, the payers will be interested in limitations that the Czech Republic can use for definitions of building land and also the terms land adjoining a building/land on which a building stands.

Building land

Considering the first mentioned issue, there are three relevant decisions of the European Court of Justice: *C-468/93 Gemeente Emmen*, *C-461/08 Don Bosco* and *C-543/11 Woningstichting Maasdriel*. The view of the court has changed slightly during the past two decades. We learn three important pieces of information from the decision of Gemeente Emmen:

- III the community lawmaker intended to exempt only the land which had not been built on and which was not supposed to be built on;
- III it is not important whether the building land is modified or not, or in what state of "preparedness for construction" it is (the general attorney adds that the current state of land is not that important. The important thing is the intention of building on it); and

¹ Act no. 235/2004 Coll., the Value Added Tax Act (the "Act" or the "VAT Act").

² Council Directive no. 2006/112/ES on the common system of value added tax (the "Directive").

³ Act no. 89/2012 Coll., the Civil Code.

III it is the individual Member State's authority to define building land.

The court in Don Bosco confirmed in its decision that the definition of the term "building land" is that of the Member State's authority, but it added that the aim and purpose of the relevant provisions of the Directive must also be taken into account (i.e. taxation of supply of the land intended to be built on). When deciding the case *Woningstichting Maasdriel*, the court states openly and clearly that **the definition of building land which does not cover all the land intended to be built on is not in accordance with the Directive**. It seems that the Member States do not have as much room when defining the building land as the *Gemeente Emmen* decision suggests, if there is any room at all.

Land adjoining a building

As mentioned above, the Directive sets out that the tax regime at the supply of the land is subordinated to the tax regime of the supply of the building on the land [article 135 sec. 1(1)]. The transaction can be a taxable supply (supply of a building together with adjoining land prior to first occupation⁴) or tax exempt supply (supply of an older building with adjoining land).

Article 135 sec. 1(j) of the Directive is quite unequivocal in respect of the mutual inseparability of a building and land from the point of view of the tax regime. It is confirmed by the only decision of the European Court of Justice which is available, *C-400/98 Brigitte Breitsohl*:

48 The next point to be made is that, without prejudice to the option which the first sentence of Article 4(3)(a)⁵ of the Sixth Directive confers upon Member States to define the words land on which they stand, the concept of supply ... of buildings or parts of buildings and the land on which they stand cannot be defined by reference to the national law applicable in the main proceedings, given the purpose of the Sixth Directive, which is aimed at determining the basis of VAT in a uniform manner according to Community rules. Such a concept, which contributes to determining the persons who may be regarded by Member States as taxable persons by virtue of Article 4(3)(a) of the directive, must therefore be interpreted in a uniform manner in all Member States.

49 It is important to note in that respect that Article 4(3) of the Sixth Directive distinguishes between, on the one hand, the supply of building land, described as any unimproved or improved land defined as such by the Member States, and, on the other, the supply before first occupation of buildings or parts of buildings and the land on which they stand, any structure fixed to or in the ground being regarded as a building within the meaning of that provision.

50 It follows from that distinction and from the wording of Article 4(3)(a) of the Sixth Directive, which refers to the supply ... of buildings or parts of buildings and the land on which they stand, that, for the purposes of VAT, buildings or parts of buildings and the land on which they stand cannot be dissociated from each other.

Unfortunately, neither the Directive nor the European Court of Justice actually sets out the definition of "land on which [a building] stands"⁶. Does the community lawmaker have in mind only directly build-up land defined, for example, by projection of the outer casing of the building, or, as the case may be, also larger land which includes a non-build-up part which is functionally connected with

⁴ I.e. within a five-year period of issuing the occupational permit as defined in sec. 56.

⁵ Today article 12 (2)(2) of the Directive which replaced the Sixth Directive as of 1 January 2007.

⁶ In the Czech version of the Directive "land adjoining the building".

the building (e.g. a garden with an access road to a family house)? Under article 12 sec. 2 of the Directive, the Member States have the authority to define the given term but it is not clear what limitations will be given by the European Court of Justice in the future. The wording of the Directive gives no clue. The term "the land on which a building stands" is used by the majority of the language versions⁷. Other versions – not a small minority – contain some other term⁸.

2. Plots of land as defined currently in Czech legislation

The current Czech legislation, in effect at least up to the end of 2013 sets out only two kinds of land:

- || **building land** as defined in sec. 56(2), whose supply is always taxable and which is a land with no buildings. A structure connected with the land with a substantial foundation can be built there on the basis of a construction permit or approval with implementation of a registered structure; and
- || **any other land**, built-up or non-built-up that is not building land whose supply is always tax exempt.

It is apparent that none of the above-mentioned modifications are in accordance with the Directive. Supply of land which is evidently appointed for building is exempt from tax in accordance with law until the moment the construction approval is issued. Defending this concept by reference to the authority of the Czech Republic to define the term "building land" is not sustainable, as the above-mentioned case law of the European Court of Justice shows. On the other hand, it is hard to find anyone in the Czech Republic who would mind this discrepancy with respect to the Directive.

In addition, the land which is sold, for example, by a developer together with new flats should be a taxable event in accordance with the Directive. I believe that a payer who for some reason prefers to be taxed rather than tax exempt could easily enforce the taxation through the direct effect of the Directive. This situation is not very likely to happen, but it is not just sheer theory. The point could be in different rates upon purchase of building land on one hand and upon sale of it together with the sale of flats on the other hand.

3. Plots of land in the amendment

The wording of the provision of section 56 of the draft amendment which was approved by Parliament but rejected by the Senate was adopted with changes in the form of a legal measure:

"Supply of selected real estate

(1) The supply of selected real estate for the purposes of tax exemption shall be the supply of

a) land,

⁷ Portugal, Malta, Slovenia, Slovakia, Italy, the United Kingdom, Sweden, France, Greece, Spain, Estonia, Latvia, Romania, Lithuania.

⁸ The used words are: interconnected, affiliated, corresponding, adjoining.

- b) the right of construction,*
- c) buildings,*
- d) underground structures with their own purpose,*
- e) infrastructure networks,*
- f) units.*

(2) The supply of selected real estate is tax exempt, such as

- a) land with no building on it connected with the land by solid foundations or infrastructure network; and*
- b) land on which a building cannot be constructed in accordance with a building permit or approval with construction of a registered building.*

(3) The supply of selected real estate other than that stated in section 2 is tax exempt after five years from issuance of the first approval of a building or from the date the building was occupied [reference to the Construction Act], whichever occurs sooner.

(4) The payer can decide that it exercises the tax after the deadline in accordance with section 3. If the payer receives a payment before effecting the taxable supply which did not cause tax liability, at the moment of effecting the taxable supply the tax base is determined in accordance to section 36."

Building land

The definition of building land is not determined in section 56 (and in any other provision). I am convinced of this despite the opposite stated in the lawmakers' report. The wording of the second paragraph of section 56 says only one thing. Supply is tax exempt for the following:

- || land which has not been built on (without an infrastructure network or real estate)
- || land without construction permit.

Please note that the supply of any other land is not tax exempt according to the paragraph. According to the paragraph, supply is not tax exempt in the following examples:

- || any land (i.e. built-up or non-built-up) with a construction permit;
- || land with or without a construction permit that contains an infrastructure network;
- || land with or without a construction permit with a building on it; etc.

I assume it would be easier for the lawmaker to define building land and exempt supply of other kinds. This way is also feasible if we realise⁹ that such provision is in article 135 sec. 1(k) of the Directive. Its aim is to exempt the supply of land which has not been built on and which is not intended to be built on. Payers should bear this in mind while applying the Act to unclear cases in real life so that they can choose a correct, non-risky tax solution for each specific transaction.

⁹

C-12/98 Amengual Far.

Land under a building

I will continue to use the term from the Czech version of the Directive (i.e. land adjoining a building), but we should not omit the other, more frequent term (i.e. land on which a building stands). As mentioned above, the tax regime for its supply should comply with the tax regime of supply of the given building. I believe that the draft of the new section 56(3) of the VAT Act more or less reflects this concept.

The third paragraph covers supply of all selected real estate stated in the first paragraph. This also means land with the exception of land whose supply is tax exempt in accordance with the second paragraph (see the previous part "Building land").

If we apply the provision to land only, it could look approximately like this:

Supply of land [a building may be part of it], with the exception of supply of land exempt in accordance with the second paragraph, is tax exempt after 5 years from issuance of the first approval of a building or from the date when the building was occupied [reference to the Construction Act] whichever occurs sooner.

The provision exempts from tax the supply of land if (i) a building is a part of it and if (ii) a period of five years elapsed from the issuance of the first approval of the building (or its first occupancy). It follows from this that, if the five-year period does not elapse, the supply of land with a building on it is a taxable event. This fulfils the aim and purpose of article 135 section 1(j) of the Directive.

The last paragraph enables taxation of the supply of land with a building on it even after the five-year period. This provision also reflects the Directive, in particular article 137 section 1(b).

It seems that the new section 56 reflects the Directive when concerning land, but numerous issues regarding the application will hopefully be resolved in the following amendment. I will attempt to inform you about some of them. The list of them is not complete yet, and practical application will bring many others.

4. Certain issues concerning application after the amendment

Definition of the term land

With the uniform European treatment in mind, we can hardly use the definition of the Real Estate Registration Act¹⁰. It actually would not help at all. The definition of land in the Real Estate Registration Act will not significantly differ from the definition in the Directive¹¹. A definition of the term "supply of land with regard to article 135 of the Directive" is missing in order to complete the aim of the provision of section 56. The definition should clarify whether land means all the land supplied in the given transaction or a part of the land specified by the number of the plot (or an analogy determined by the laws of the individual Member States) or whether it is possible and correct

¹⁰ Act no. 256/2013 Coll., Real Estate Registration (effective from 1 January 2014).

¹¹ See e.g. the opinion of Juliane Kokott re: *C-428/02 Fonden Marselisborg*.

to separate the land supplied in the given transaction (i.e. divide it by a given ratio) and treat each of the parts with its own tax regime. Each of the variations can be supported or opposed with proper arguments: indivisibility of a single economic transaction¹², the need to fulfil the purpose and aim of the law/Directive, section 36(7) of the VAT Act. Let's think about, for example, the sale of land which consists of two adjoining plots of land where one bears a building permit and the other one does not.

Definition of the term land adjoining a building

As mentioned above, the supply of land adjoining a building will have the same tax regime as the supply of the building. If the supply contains a building and only the land under the building (for example, a plot of land in a town where the individual buildings are close to each other and every piece of the land is built-up), then there would be no problems with VAT. If the supply is taxable or tax exempt, the tax base (or the value of the supply) would be the whole payment. In such a case, the absence of a clear definition of the term land adjoining a building would not matter.

As another example, we can consider the sale of land with a family house on it. Only a part of the land is built-up, there is a garden around the house, a yard, and a parking place. According to the purpose of the kind of land, they are (i) a built-up area and yards and (ii) other area (I use the terms from the Real Estate Registration Act to illustrate the case, and I suppose they will not significantly affect the application of the VAT Act). Will each part of the land have its own tax regime? Or is the supply only one piece of land with a building as one indivisible supply with a single tax regime?

The last example is supply of the land with a building and an adjoining garden (i.e. two plots of land). According to the purpose, the land is (i) a built-up area and yards and (ii) a garden. Will the transaction be considered for the purposes of VAT as (i) a supply of land with a building (exempt or taxable depending on the five-year period) and (ii) a supply of land – garden which is tax exempt under section 56(22)? Or will the garden be considered as land adjoining the building and its supply reflecting the supply of a plot of land with a building?

The last two mentioned examples can be treated in another way: the part of the land which is directly built-up would be separated and treated with the tax regime according to section 56(3) (tax exempt or taxed with respect to the five-year period) and the rest of the transaction would be a tax exempt supply under section 56(2) of the VAT Act.

It is up to each payer how it will assess any specific transaction. Only one thing is for sure: there will be no universal rules on how to proceed until the relevant provisions are clarified by an amendment. Each transaction should be assessed individually with respect to not only the provisions of law and general principles, but also with respect to the aim and purpose of the relevant articles of the Directive.

Separate sale of land under a building

Also in 2014, land can be supplied separately without the building which stands on it. The law does not clarify whether section 56(3) can be used even for this kind of supply. In my view, a different interpretation would be inconsistent with the Directive. The community lawmaker surely did not intend to tax the separate supply of land with, for example, a hundred-year old building still in use which stands on it. The lawmaker only did not count on the separate sale, and this is why explicit regulation

¹²

See e.g. *C-173/88 Morten Henriksen*.

is not found in the Directive. I believe that the five-year period regarding a building will also be decisive for determining the tax regime of supply of a separate plot of land under a building.

Tax rate

Under section 48(a), the reduced tax rate will apply to transfer of buildings designated for social housing. In 2014, many buildings will be supplied during the sale of land together as its part. Does it mean that the sale of land (with a building designated for social housing on it) will be in the base rate, but when sold separately as a building for social housing, the reduced rate will apply? Such an interpretation of the second paragraph of section 48(a) would not make sense. I believe that the provision should be interpreted in accordance with its sense and purpose and not the wording.

5. Conclusion

It is apparent that the amended section 56 provides creative individuals with limitless possibilities. One could object that a little bit of legal certainty would not harm anybody. It might be wise to be alert when solving transactions with land, especially in the beginning before the legal opinions settle or before the Coordinating Committee of the General Financial Directorate and the Chamber of Tax Advisors of the Czech Republic meet and discuss their contributions.

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