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A Practical Insight to Cross-Border Corporate Tax Work—Czech Republic

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General: Treaties

How many income tax treaties are currently in force in your jurisdiction?

The Czech Republic is currently bound by 71 treaties and has a widespread network of treaties with countries leading the world economy as well as with the perspective markets of Asia and of central and eastern Europe. New opportunities continue to be pursued: a treaty with the Federal Democratic Republic of Ethiopia is in the process of ratification and a new treaty with Austria and with the Republic of Tajikistan will enter into force as of January 1, 2008.

Do they generally follow the OECD or another model?

The OECD Model Tax Convention is generally followed, with some exceptions, including withholding tax on software and permanent establishment definition relating to provision of services for more than six months. Tax treaties with some of the less-developed countries are based on the UN Model tax convention. The 1993 Czech-US tax treaty was concluded based on the then applicable US Treasury Department's draft Model Tax Convention on Income and Capital and the OECD Model Tax Convention.

Do treaties have to be incorporated into domestic law before they take effect?

No, once a binding treaty is ratified with the consent of the Parliament and published in the Collection of International Treaties, it directly becomes an integral part of the domestic legal system.

Do they generally incorporate anti-treaty shopping rules (or "limitation of benefits" articles)?

Model-based principles, such as the "beneficial owner" or "place of effective management" concept, are generally applied; however, "limitation of benefits" clauses are rare, as is the case in the Czech-US tax treaty.

Are treaties overridden by any rules of domestic law (whether existing when the treaty takes effect or introduced subsequently)?

No, subject to the proper process of ratification and publication, a tax treaty prevails over domestic legislation irrespective of subsequent or previous national laws. Even though not legally binding, directives on the application of tax treaties issued by the Ministry of Finance should also be taken into consideration as they provide government-approved guidelines.



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Transaction Taxes

Are there any documentary taxes in your jurisdiction?

There are no documentary taxes in the Czech Republic. The stamp duty, which, in certain countries, related to documentary taxes, is applied in the Czech Republic only in the form of the standard court and administrative fees.

Do you have Value-Added Tax (or a similar tax)? If so, at what rate or rates?

There is value-added tax (VAT) in the Czech Republic. Upon the accession to the European Union, the Czech Republic introduced the legislation implementing the European VAT Directives.

Two VAT rates are applied in the Czech Republic:

- The standard rate of 19 percent for most of taxable supplies
- The reduced rate of nine percent (effective from January 1, 2008) mainly for those taxable supplies permitted by the Sixth Council Directive (77/388/EEC, Article 12) and for supplies related to certain residential housing

Is VAT (or any similar tax) charged on all transactions or are there any relevant exclusions?

In principle, entities and individuals registered for Czech VAT must charge VAT on the supply of most goods and services. However, there are many exclusions from this rule, for example, banking, insurance and financial operations, postal services, public radio and television broadcasting or the sale or lease of land or buildings.

The above-mentioned example supplies are exempt from VAT without right of VAT deduction. There are also VAT-exempt taxable supplies allowing the supplier to deduct input VAT, which results in an effective VAT rate of zero percent. This is generally in line with the EU VAT rules.

Is it always fully recoverable by all businesses? If not, what are the relevant restrictions?

As a general rule, businesses registered for VAT are entitled to deduct the input VAT paid on supplies of goods and services used for their economic activities.

If a business uses received taxable supplies within its economic activity, which is exempt from VAT without the right of VAT deduction or for any other non-business activity, input VAT paid on such taxable supplies cannot be deducted.

This is generally in line with the EU VAT rules.

Are there any other transaction taxes?

There are more taxes applicable to transactions in the Czech Republic. These are as follows:

- Gift tax in the range of seven percent to 40 percent, levied on the value of property, reduced by related debts and other liabilities, donated between certain (non-related) individuals and between legal entities
- Inheritance tax in the range of 3.5 percent to 20 percent levied on the net value of property inherited by certain non-related individuals and by legal entities
- Real estate transfer tax of three percent levied on the higher of purchase price or administrative value of transferred real estate

Are there any other indirect taxes of which we should be aware?

Besides VAT, there are also excise taxes levied on consumption of mineral oils, used oils, alcohol, beer, wine and intermediate products and tobacco products.

In addition, as of 2008, three new environmental taxes have been introduced. These so-called “energy taxes” are levied on supplies of electricity, natural and other gases and solid fuels and are paid by the suppliers of the fuels to end-users in the Czech Republic.

Cross-Border Payments

Would there be any WHT on royalties paid by a local company to a non-resident?

Payments for the use, or the right to use, of industrial rights, software, know-how and copyrights as well as for leasing of equipment are subject to withholding tax at a rate of 15 percent as of January 1, 2008, if paid to a non-Czech resident. There is a reduced five percent rate for financial leases. This tax rate can be reduced by virtue of the relevant double taxation treaty. Usually the rate for copyright royalties is lower (or nil) than the rate for industrial royalties.

The EU Interest and Royalty Directive was implemented into Czech law with respect to royalties effective from January 1, 2011. Royalty payments to qualifying residents of the EU Member States and Switzerland will be then exempt from WHT if the directive criteria are met.

Would there be any WHT on interest paid by a local company to a non-resident?

There is a 15 percent withholding tax on interest paid to foreign residents. This rate is reduced by the virtue of most tax treaties; often the treaty rate is nil.

The EU Interest and Royalty Directive (I/R Directive) was implemented into the Czech law, for interest effective from May 1, 2004. This means that interest payments to qualifying residents of the EU Member States and Switzerland are exempt from WHT if the directive criteria are met. Prior consent of the tax authorities is required for the application of the I/R Directive exemption.

The I/R Directive exemption does not apply to interest from loans and credits agreed upon between affiliated persons at non-arm's-length terms or in excess of thin capitalization rules. The exemption further does not apply to interest from profit-participating loans or loans convertible into equity.

Would relief for interest so paid be restricted by reference to "thin capitalisation" rules?

Indeed, interest on loans is tax deductible only up to the limit of loans that fulfill a specific debt-to-equity ratio and other conditions under thin capitalisation rules.

In addition to interest, other financial expenses (e.g., loan arrangement fees, guarantee fees) are subject to the thin capitalisation rules as of January 1, 2008. Expenses on credits and loans will be non-deductible for corporate tax purposes if:

- They exceed a certain percentage cap of the outstanding loans and credits. The cap rate will be calculated as a base rate plus four hundred basis points
- They arise from subordinated debts of the taxpayer
- The interest on a credit or a loan is dependent on the borrower's profits
- The total of credits and loans from related and unrelated parties exceeds six times the equity in the tax period (four times from 2009)
- The total of credits and loans from related parties exceeds two times equity (three times for banks and insurance companies)

The base rate will be equal to the average interest rates on interbank deposits for the particular currency. Loans and credits provided by a third party, but guaranteed by a related party, would also be regarded as having been granted by a related party. The restrictions will not apply to expenses below CZK 1 million on loans and credits from unrelated parties. The 2008 thin cap provisions will only apply to loans taken before 2008 as of 2010. The related party loans in place before 2008 will therefore continue to be limited only by the 4:1 debt-to-equity ratio.

The interest disallowed by the "thin capitalisation" provisions is reclassified and treated as a dividend for the purposes of domestic law unless an applicable double-tax treaty provides otherwise.

The 2008 thin cap provisions are rather broad and difficult to implement. Certain guidelines are expected to be published.

If so, is there a “safe harbour” by reference to which tax relief is assured?

Please see above.

Would any such “thin capitalisation” rules extend to debt advanced by a third party but guaranteed by a parent company?

Yes, see above. Please note that also any third-party loans will be subject to thin capitalisation as of 2008.

Is any withholding tax imposed on dividends paid by a locally resident company to a non-resident?

There is statutory 15 percent withholding tax on dividends paid to a Czech non-resident, which may be reduced by virtue of the double tax treaties. Usually, the reduction is to ten percent or five percent; the reduction to nil is rare (applicable e.g., to dividends paid on qualifying shareholding to the Netherlands).

No withholding tax is due on dividend distributions by Czech capital companies to their EU/EEA parents provided that the Parent-Subsidiary Directive conditions are fulfilled (see Section 5 for more details). This exemption is also applied to dividends paid between two Czech companies.

Does your country have transfer pricing rules?

Yes. Generally, if the prices charged between related parties differ from the usual (market-level) prices and the difference is not properly substantiated, the Tax Authorities may adjust the taxpayer’s tax base by the difference ascertained. Related parties are defined as persons related through capital (ownership of at least 25 percent of capital or voting shares), economically (e.g., one entity is controlled by the other entity or two entities controlled by the same entity) or in another manner (e.g., engaged in a transaction primarily in

order to record lower profits or higher tax losses). Soft reference to OECD Transfer Pricing Guidelines is made by official interpretations.

This rule applies both to domestic and cross-border transactions. From January 2006, the taxpayers may ask for a binding ruling confirming the method of determination of the prices agreed upon between related parties.

Tax on Business Operations: General

What is the headline rate of tax on corporate profits?

The headline tax rate on corporate profits is 21 percent in 2008. This rate will decrease to 20 percent in 2009 and to 19 percent in 2010.

A rate of 15 percent applies to certain specified income e.g., certain dividends and similar income from abroad.

Investment funds, unit trusts and pension funds are subject to tax at a reduced rate of five percent.

When is that tax generally payable?

Income tax is, in general, payable within three or six months after the end of the taxable period (calendar or fiscal year).

Taxpayers whose tax liability exceeds certain limits are obliged to pay tax advances that are calculated based on their most recent tax liability. Advance payments are due semi-annually or quarterly.

What is the tax base for that tax (profits pursuant to commercial accounts subject to adjustments; other tax base)?

The tax base for corporate income tax purposes is generally determined as profits stated in commercial accounts prepared in accordance with the Czech accounting legislation, subject to adjustments.

If it otherwise differs from the profit shown in commercial accounts, what are the main other differences?

Main differences include:

- Expenses not incurred to generate, ensure and maintain taxable income
- Adjustments resulting from differences between accounting and tax depreciation of fixed assets
- Tax non-deductible items e.g., gifts and donations, entertainment expenses, expenses related to non-taxable income, accounting provisions and accounting reserves, fees paid to members of company statutory bodies, unpaid contractual fines and penalties, losses realised on the sale of land, receivables and specified securities, etc.
- Items, which can be deducted from tax base to a certain limit only, e.g., travel expenses above statutory limits, certain employment benefits
- Expenses that are deductible only when paid, such as contractual fines and penalties or social security and health insurance
- Items not shown in the accounting which increase the tax base e.g., income in-kind or transfer pricing adjustments
- Certain interest expenses exceeding thin capitalisation limits
- Items exempt from taxation, taxed at a special tax base or subject to withholding tax e.g., dividends, income from small water power plants, subsidies and grants, etc.
- Items reducing the tax base e.g., tax losses carried forward, reinvestment deductions, certain gifts and donations

The above list is not exhaustive.

Are there any tax grouping rules? Do these allow for relief in your jurisdiction for losses of overseas subsidiaries?

No corporate income tax grouping scheme is in place.

Recent amendment to the Czech laws introduced grouping for VAT purposes to be firstly used as of 2009 on a voluntary basis.

Is tax imposed at a different rate upon distributed, as opposed to retained, profits?

No. Tax rates (see question 4.1) apply regardless of whether the profits are distributed or retained.

Dividend distribution is generally subject to withholding tax of 15 percent subject to relevant exemptions (EU Parent-Subsidiary Directive) or reductions under the applicable double-taxation treaties.

What other national taxes (excluding those dealt with in “transaction taxes”, above) are there—e.g., property taxes, etc.?

In addition to above-mentioned taxes, there are two more taxes applicable to legal entities:

- Real estate tax levied on land or buildings located in the Czech Republic
- Road tax generally levied on the vehicles registered in the Czech Republic for commercial purposes

Are there any local taxes not dealt with in answers to other questions?

There are no taxes levied at the local level in the Czech Republic. However, local authorities impose quasi-taxes known as “local fees”. There is a broad array of local fees e.g.:

- Fee on usage of public space
- Fees on admission

- Fees on accommodation capacity
- Fees on slot machines and gaming
- Fees on operating a system of collection, transport, sorting, use and disposal of communal waste

Capital Gains

Is there a special set of rules for taxing capital gains and losses?

Capital gains made on the transfer of a qualifying subsidiary will be exempt as of January 1, 2008. Qualifying holdings are defined in the same way as the dividend exemption. (See question 5.3)

If so, is the rate of tax imposed upon capital gains different from the rate imposed upon business profits?

Exempt (see above).

Is there a participation exemption or relief for reinvestment?

As of January 1, 2008, a participation exemption will generally apply to income from dividends or from the sale of shares derived by the Czech resident shareholder or permanent establishment of other EU member state located in the Czech Republic from a subsidiary resident in the EU or a country with which the Czech Republic has concluded a double-taxation treaty.

In respect of the qualifying EU/EEA subsidiaries, the conditions for the exemption include, most notably, the ownership of at least ten percent for an uninterrupted period of 12 months.

In respect of foreign non-EU/EEA subsidiaries, all the following requirements have to be met:

- Subsidiary is a resident in the EU member state or a country with which the Czech Republic has concluded a double-taxation treaty
- Subsidiary is subject to corporate tax comparable to the Czech Republic taxation (generally, at a rate of at least 12 percent and on a similar basis)
- The ownership interest of the parent company in the share capital of the subsidiary is (or will be) at least ten percent for an uninterrupted period of 12 months
- Subsidiary is a similar foreign company comparable to a Czech joint stock company, limited liability company or cooperative. The individual tax relief might be granted in the form of investment and other incentives, but the relief is not strictly connected with reinvesting the company's profit

Branch or Subsidiary?

What taxes (e.g., capital duty) would be imposed upon the formation of a subsidiary?

No taxes are imposed on the formation of a subsidiary.

Are there any other significant taxes or fees that would be incurred by a locally formed subsidiary but not by a branch of a non-resident company?

There are certain notary fees related to the establishment of a subsidiary (calculated as a percentage of the basic capital and limited by a cap). A locally formed subsidiary as a separate legal entity with its seat in the Czech Republic will be subject to taxation on its worldwide income and gains as opposed to a branch which will, if the conditions are met, generally be considered as a permanent establishment. Nonetheless, the tax rates and the determination of the tax base are usually identical for both cases.

On the contrary, a Czech securing tax is applicable to certain payments to non-EU non-residents. This tax would typically apply to payments of income to a branch and would be offset against the final Czech tax liability of the branch.

How would the taxable profits of a local branch be determined?

Under Czech laws, a branch of a foreign company registered in the Commercial Register is an accounting unit and must maintain double-entry bookkeeping in accordance with the Czech accounting legislation. The tax base is determined by adjusting the pre-tax profit in accordance with the Income Tax Act. Subject to the rule that the tax base of a branch may not be lower than that of a resident taxpayer conducting similar activities and subject to prior consent of the financial authorities, other methods establishing the tax base may be applied (e.g., commissions received, number of employees, etc.).

Would such a branch be subject to a branch profits tax (or other tax limited to branches of non-resident companies)?

There is no branch profits tax.

Would a branch benefit from tax treaty provisions, or some of them?

A branch will usually fall under the scope of a permanent establishment in accordance with the tax treaty concluded with the company's country of origin and income and gains of the company will ultimately be taxed in the Czech Republic subject to Article 7 of the OECD model convention. Also, under the appropriate tax treaty, anti-discrimination rules apply so the branch may not be subject to worse tax conditions than domestic residents conducting similar activities.

Whether the branch, permanent establishment, can benefit from other Czech tax treaties is rather unclear. There is little or no legislative guidance to deal with triangular cross-border situations.

Would any withholding tax or other tax be imposed as the result of a remittance of profits by the branch?

There are no limitations on the remittance of profits by the branch.

Anti-Avoidance

How does your jurisdiction address the issue of preventing tax avoidance? For example, is there a general anti-avoidance rule or a disclosure rule imposing a requirement to disclose avoidance schemes in advance of the company's tax return being submitted?

Czech tax legislation includes general substance-over-form and anti-abuse provisions. Recent rulings of Czech courts also tend to dismiss certain tax structures on the grounds of circumvention of public law. The doctrine usually requires a non-tax economic purpose for a transaction. No special disclosure schemes exist.

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