CHAMBERS

Global Practice Guides

Corporate Tax

Law and Practice – Czech Republic

Contributed by

Kocián Šolc Balaštík,

advokátní kancelář, s.r.o.

2018

CHAMBERS® AND PARTNERS

CZECH REPUBLIC

The 'Law & Practice' sections provide easily accessible information on navigating the legal system when conducting business in the jurisdiction. Leading lawyers explain local law and practice at key transactional stages and for crucial aspects of doing business.

Law and Practice

Contributed by Kocián Šolc Balaštík, advokátní kancelář, s.r.o.

CONTENTS

Kocián Šolc Balaštík, advokátní kancelář, s.r.o. is one of the largest law firms in the Czech Republic, with over 25 years' experience on the market. Based in Prague, with branch offices in Karlovy Vary and Ostrava, it has nearly 70 legal and tax advisers, providing comprehensive advice to domestic and foreign clients. Areas of particular expertise include: tax laws, banking/insurance/finance/capital markets, corporate law, IP, M&A, competition and anti-trust. KSB is a founding member of the World Services Group, a network of law firms and other professional advisors in more than 115 countries worldwide; it is also a member of the International Attorneys Club, a global association of leading law firms, and of the Employment Law Alliance, an international network of law firms advising on labour law.

Authors

Helena Navrátilová is a tax partner at the firm. She specialises in the tax aspects of business transactions, international taxation and tax planning, corporation tax, personal income tax, taxation of not-for-profit organisations, and tax administration and proceedings. Helena has advised many international corporations as well as Czech companies, also assisting private equity investors and property companies on corporate structuring, operations and supply contracts. She has published a number of professional articles on aspects of taxation law and is a member of the Czech Chamber of Tax Advisors.

Jan Černohouz is a tax advisor and counsel at KSB. His practice focuses primarily on corporation tax, international taxation, tax planning and corporate VAT, VAT for non-profit and state organisations and excise taxes. Jan has been involved in corporate income tax and VAT compliance, M&A projects, due diligence work and other tax advisory work for major companies operating in a wide range of industries including automotive, food, healthcare, solar energy and television/radio broadcasting. He is a member of the Czech Chamber of Tax Advisors.

1. Types of Business Entity, Residence and Tax Treatment

1.1 Corporate Structures and Tax Treatment

Larger businesses in the Czech Republic often take the form of a capital company, particularly a limited liability company (*společnost s ručením omezeným; s.r.o.*), a joint-stock company (*akciová společnost; a.s.*) or, less frequently, a co-operative (*dužstvo*). The common characteristic of these capital corporations is that their members are not personally liable for the debts and obligations of the corporation; the corporations have legal personality and are independent of their members.

The corporations are individual corporate income taxpayers and are taxed as separate legal entities. The corporate income tax base of any corporation is established in accordance with the same rules stipulated in the Income Tax Act ("ITA"). A few exceptions apply to specific taxpayers, such as investment funds, trusts, non-profit organisations, etc.

1.2 Transparent Entities

Personal companies are less common, and entail full personal liability of their general members. They take the legal form of a general partnership *(veřejná obchodní společnost; v.o.s.*) or a limited partnership or kommandit company (*komanditní společnost; k.s.*) General partnerships are tax transparent, and limited partnerships are semi-transparent in relation to the general partners. The activity of a transparent entity whose members are non-local persons gives rise to a permanent establishment of those members in the Czech Republic.

The transparent entities are mainly used in international group structures that involve corporate entities as general partners. Due to the unlimited liability of the general partners and the lack of any tax advantage, they are not very common in domestic structures. Joint-stock companies with variable capital (SICAV) are more widely used as investment vehicles.

1.3 Determining Residence

Pursuant to the ITA, a corporation is deemed to be resident in the Czech Republic for corporate tax purposes if it has its registered office or place of (effective) management in the Czech Republic. The place of management is deemed to be the address of the place from which the entity is managed, and "management" is considered to be the day-to-day management rather than strategic decision-making only. Every case needs to be assessed on its own individual facts and circumstances.

1.4 Tax Rates

The corporate income tax rate is 19%. Income of qualified investment funds is subject to a 5% tax rate. Foreign source

shares in profit, including dividends, settlement shares, shares in liquidation proceeds and similar types of income, are included in a separate tax base, which is subject to a 15% tax. The tax withheld in accordance with the tax rates stipulated in the income tax treaties may be credited to the 15% Czech tax liability.

2. Key Features of the Tax Regime

2.1 Calculation of Taxable Profits

Taxable profits are calculated based on the accounting result. Every corporate entity seated or doing business in the Czech Republic is obliged to keep accounting books according to Czech accounting standards. The entity may keep accounting books based on international accounting standards (IAS) only if it issues securities accepted for trading on the European regulated market, but is required to adopt its accounting result to the Czech accounting standards in order to establish the starting point for the corporate income tax base calculation.

Accounting results that are computed on an accrual basis are subsequently adjusted for tax purposes, pursuant to the Czech ITA. The most significant adjustments are as follows:

- interest and other costs relating to loans from related parties calculated from the amount of the principal exceeding four times the equity;
- representation costs;
- some reserves and provisions;
- unpaid contractual interest and penalties;
- unpaid real estate tax and real estate transfer tax;
- unpaid health insurance and social security contributions due from the employer for its employees; and
- shortages and damages, etc.

2.2 Special Incentives for Technology Investments

Expenses incurred by Czech tax payers for R&D purposes can be used as general costs (if not capitalised), and can also be used as an item decreasing the tax base. This means that if all statutory conditions are met, 200% of R&D expenses is allowed to decrease the accounting profit of the taxpayer in a tax period. However, the taxpayer must prepare an R&D project and comply with certain requirements set out in the ITA in order to be able to use such expenses as an item decreasing its tax base.

2.3 Other Special Incentives

Czech tax law supports pension funds with a corporate income tax rate of 0%, and supports qualified investment funds with a special 5% income tax rate. There are also government projects under which substantial tax relief is available for certain investments.

2.4 Basic Rules on Loss Relief

Tax losses can be used to offset future profits disclosed in the five tax periods immediately following the tax period in which the tax loss was incurred. However, certain restrictions apply in cases where the taxpayer that incurred the tax loss is involved in a company reorganisation, or where there was a substantial change in the composition of the persons directly participating in equity or control of the taxpayer.

2.5 Limits on Deduction of Interest

Czech tax law includes thin capitalisation rules, which limit the tax deductibility of interest and other costs relating to loans from related parties, calculated from the amount of the principal exceeding four times the equity (six times if the taxpayer is a bank or an insurance company).

2.6 Basic Rules on Consolidated Tax Grouping

No consolidated tax grouping is available in the Czech Republic. As each entity is considered a separate taxpayer, there is no possibility to utilise the tax losses on a group level without prior steps (eg, merger of the companies).

2.7 Capital Gains Taxation

Capital gains are included in the general corporate income tax base.

However, if the capital gain is realised with respect to a subsidiary in which a Czech capital corporation holds a share of 10% or more for at least 12 consecutive calendar months and the subsidiary is a Czech tax resident or a tax resident in an EU member state, such income is exempt from taxation in the Czech Republic. In addition, capital gains realised in connection with subsidiaries which are tax residents in contracting states are exempt from Czech corporate income tax under similar conditions and provided that the subsidiary has an appropriate legal form and is subject to tax similar to corporate income tax of at least 12%.

2.8 Other Taxes on Transactions

Transactions that directly concern real estate are generally subject to real estate transfer tax at a rate of 4%. The tax is paid by the enquirer. No other taxes are payable on transactions.

2.9 Other Notable Taxes

Real estate is subject to real estate tax. If the taxpayer uses a road motor vehicle for business purposes, then the taxpayer is liable to pay road tax. No other direct taxes are notable in the Czech Republic.

3. Division of Tax Base Between Corporations and Non-Corporate Business

3.1 Closely Held Local Businesses

Most closely held local businesses often operate in an entrepreneurial (individual) form. However, larger and more widely operating businesses in the Czech Republic usually take the corporate form of a capital company, in particular a limited liability company.

3.2 Corporate Rates and Individual Rates

There are neither rules nor restrictions to prevent individuals from operating their business in a corporate form and thus have their income taxed at corporate tax rates. However, due to the fact that the individual and corporate tax rates do not differ significantly, a detailed analysis of the benefits resulting from doing business in a corporate/entrepreneurial (individual) form is advisable.

3.3 Accumulation Earnings for Investment Purposes

There are no rules to prevent a closely held corporation from accumulating earnings for investment purposes.

3.4 Sales of Shares in Closely Held Corporations

Dividend income of an individual received from a Czech corporation tax resident is taxed at the source at a 15% tax rate. Dividend income received from a Czech tax non-resident is included in the recipient's tax return, and is also subject to tax at a 15% rate.

Income from a sale of shares in closely held corporations is taxed within the individual's tax return at a 15% tax rate. However, if the individual holds such share in a limited liability company for a minimum period of five years or in a joint-stock company for a minimum period of three years, the income from the sale of such share is exempt from taxation.

3.5 Sales of Shares in Publicly Traded Corporations

Taxation of dividend income from publicly traded corporations is the same as for closely held corporations. This means that dividend income of an individual received from a Czech tax resident is taxed at the source at a 15% tax rate. Dividend income received from a Czech tax non-resident is taxed within the recipient's tax return, also at a 15% tax rate.

Income from a sale of shares in publicly traded corporations is taxed within the individual's tax return at a 15% tax rate. However, the income from such sale is exempt from taxation if the individual holds the shares for at least three years.

4. Key Features of Taxation of Inbound Investments

4.1 Withholding Taxes

In the absence of income tax treaties and also in the event that a person does not qualify for treaty benefits that would otherwise be available, the withholding tax rate is 35% of the gross interest, dividend or royalty income.

4.2 Primary Tax Treaty Countries

Traditionally, the main tax treaty countries that foreign investors have used to make investments in Czech stocks or debt are the Netherlands, Luxembourg, the United Kingdom and Cyprus. The relative weight of these countries has been diminishing in light of the relatively favourable Czech corporate income tax regime and parent-subsidiary tax exemptions.

4.3 Use of Treaty Country Entities by Non-Treaty Country Residents

Evidence of beneficial ownership and tax residence certification are the key requirements from the Czech tax administration for providing access to tax treaty benefits. The general and certain specific tax anti-avoidance rules enable the Czech tax authorities to deny treaty benefits to conduit entities and in other "treaty shopping" situations.

4.4 Transfer Pricing Issues

The most significant transfer pricing cases concern fees for management, technical and manufacturing services. The assessment and documentation of revenue and costs allocation to permanent establishments is also a focus of tax inspections.

4.5 Related Party Limited Risks Distribution Arrangements

The Czech tax authorities challenge toll manufacturing and the limited risk distribution for the sale of goods arrangements from the transfer pricing perspective. In addition, they request evidence that the initial consideration for the business restructuring has been set at arms' length and duly paid.

4.6 Variation from OECD Standards

The Czech tax authorities have transformed the OECD standards into local guidelines and tax administrative practices and, in general, follow the OECD model guidelines quite closely, although in some areas the day-to-day practice may be a bit more lenient. The transfer pricing documentation is not obligatory; however, the taxpayer carries the burden of proof in accordance with the general tax administration rules in any case.

5. Key Features of Taxation of Non-Local Corporations

5.1 Taxation of Non-Local Corporation Versus Local Subsidiaries

The corporate income tax base is established in accordance with the same ITA rules for both local branches of non-local corporations and local subsidiaries of non-local corporations. Differences occur between the tax treatment of profit distribution by a subsidiary to a non-local parent company and transfer of profit by a branch to its non-local head office when the latter suffers no withholding tax. Further differences will be in the tax treatment of interest, royalties, finance lease payments, etc, where no withholding tax applies to payments by the local branch.

5.2 Capital Gains of Non-Residents

In general, non-residents' capital gains on the sale of stock in local corporations are taxable in the Czech Republic. Most tax treaties, however, allocate the right to tax the capital gain to the state of residence of the seller. The most notable exception would be the tax treaty with Germany, which grants the right to tax the capital gains on the sale of stock in local corporations to the Czech Republic, unless there is a tax exemption available under relevant provisions of the ITA.

Czech income tax law does not impose tax on the capital gains on the shares of a non-local holding company that holds the shares in a local company directly. Hence, there is no taxation of indirect capital gains in the Czech Republic.

5.3 Change of Control Provisions

There are no such provisions that would trigger tax or other charges to the disposal of an indirect holding either in a group of companies or to a third party.

5.4 Determining the Income of Foreign-Owned Local Affiliates

There are no formulas used to determine the income of either foreign-owned local affiliates or the locally-owned companies selling goods or providing services. The corporate income tax base determination is based on the accounting result and further adjustments thereto in accordance with the relevant provisions of the ITA.

5.5 Deductions for Payments by Local Affiliates

The management and administrative expenses incurred by a non-local affiliate can only be charged as part of the service fee. However, the service fee must be established and evidenced in accordance with the arm's length principle and rules set in accordance with the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration. The Czech tax authorities frequently focus on examining transfer prices during their tax inspections.

5.6 Contraints on Related Party Borrowing

No specific rules or constraints are imposed on related party borrowing by foreign-owned local affiliates. The interest costs deduction is regulated by thin capitalisation rules applicable to any related party borrowing by corporate income tax payers.

6. Key Features of Taxation of Foreign Income of Local Corporations

6.1 Foreign Income of Local Corporations

In general, the foreign source income of local corporations is not exempt from corporate income tax, and is generally included in the general corporate income tax base, subject to tax at the rate of 19%. Relevant expenses can be deducted.

Gross dividends and other shares in profit, liquidation proceeds, settlement shares, etc, are included in a separate corporate income tax base, subject to a 15% tax. The tax value of relevant acquisition costs can be deducted from the liquidation proceeds or settlement share.

6.2 Non-Deductible Local Expenses

Expenses attributable to foreign source or local income that are exempt from tax – including in some cases future anticipated exempt income – are not deductible for corporate income tax purposes. For the purpose of calculating the corporate income tax base, costs that are attributable to the exempt income both directly and indirectly must be taken into account.

6.3 Taxation on Dividends from Foreign Subsidiaries

Dividends distributed by both foreign and local subsidiaries may be exempt from tax, provided that some conditions laid down in the ITA are satisfied. These conditions include that the parent company must have a minimum 10% share in the registered capital of the subsidiary, held for at least 12 months, and that both the parent and the subsidiary must have the legal form stipulated in the relevant EU parent-subsidiary directive.

Similar rules apply to shareholdings of local companies in foreign subsidiaries located in tax treaty countries. In addition, some conditions must be met – in particular, the income of the foreign subsidiary must be subject to tax at a rate of at least 12% and its legal form must be comparable to the key legal features of a limited liability company, a joint-stock company or a co-operative as set out in the Czech laws.

6.4 Use of Tangibles

The transfer of rights to intangibles must be performed on conditions that would apply among separate and independent entities. Consequently, local corporate income tax is trig-

gered by the local corporations charging the licence fees, royalties, etc, to their non-local subsidiaries.

6.5 Taxation of Income of Non-Local Subsidiaries Under CFC-Type Rules

The Czech Republic has no CFC rules. The Czech corporate income tax treatment of foreign branches of Czech corporations is generally included in the domestic corporate income tax base, and foreign tax can be credited to the Czech corresponding tax liability unless the relevant tax treaty provides for a tax exemption of the branch's income from Czech corporate income tax.

6.6 Rules Related to the Substances of Non-Local Affiliates

The substance requirement, genuine business reason and purpose of involvement of a foreign subsidiary in a transaction is subject to general anti-avoidance rules and tests.

6.7 Taxation on Gain on the Sale of Shares in Non-Local Affiliates

Capital gains generated on the sale of shares in both foreign and local subsidiaries may be exempt from corporate income under the same conditions as the dividend income exemption. These conditions include that the parent company must hold a minimum 10% share in the registered capital of the subsidiary, held for at least 12 months, and that both the parent and the subsidiary must have the legal form stipulated in the relevant EU parent-subsidiary directive.

Similar rules apply to shareholdings of local companies in foreign subsidiaries located in tax treaty countries. Moreover, some additional conditions apply – in particular, that the income of the foreign subsidiary must be subject to tax at a rate of at least 12%, and the legal form of the subsidiary must be comparable to the key legal features of a limited liability company, a joint-stock company or a co-operative as set out in the Czech laws.

Kocián Šolc Balaštík, advokátní kancelář, s.r.o.
Jungmannova 745/24
110 00 Prague 1
Czech Republic

Tel: (+420) 224 103 316
Fax: (+420) 224 103 234
Email: info@ksb.cz
Web: www.ksb.cz

7. Anti-Avoidance

7.1 Overarching Anti-Avoidance Provisions

The Tax Procedure Code stipulates the substance-over-form rule, and the decisions issued by the Supreme Administrative Court have paved the way for a well-founded general anti-tax avoidance approach, which is generally applied fairly consistently by the courts.

Specific provisions in place include thin capitalisation rules, and a principal purpose test for mergers and other company reorganisations, etc.

8. Other

8.1 Regular Routine Audit Cycle

The requirements for an accounting audit are stipulated in the Act on Accounting. Corporations must test their obligation to have their annual financial statement audited against the following benchmarks.

The following accounting entities are required to have their regular or extraordinary financial statements audited:

- large accounting entities;
- medium accounting entities;
- small accounting entities, if they are joint-stock companies and if they have exceeded or attained at least one of the following figures on the balance sheet date of the accounting period for which the financial statements are audited, and for the immediately preceding accounting period:
  (a) assets in total of CZK40 million;
  (b) annual total net turnover of CZK80 million; or
  (c) average number of employees during the accounting period equals 50;
- other small accounting entities, if they have exceeded or attained at least one of the figures listed in a), b) or c) above on the balance sheet date of the accounting period for which the financial statements are audited, and for the immediately preceding accounting period.