



MERGERS AND ACQUISITIONS

Czech Republic

Taxation of Cross-Border
Mergers and Acquisitions

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TAX

Czech Republic

Introduction

Czech law contains a variety of special provisions applying to mergers and acquisitions (M&A) in areas such as company law, competition, environmental protection, accounting, and tax. Unlike many jurisdictions, however, the Czech Republic had no detailed tax legislation dealing with M&A before European Union accession (1 May 2004), when legislation enacting the EU Merger Directive came into effect. Even after the enactment of these provisions, which in general simply repeat the terms of the directive, the accounting rules on reorganizations and acquisitions tend to determine many aspects of the tax effects.

In general, an acquisition can be structured as a purchase of either a legal entity or assets (possibly the entire business). Depending on the requirements of the purchaser, it may be appropriate to form a Czech legal entity to make the acquisition. Further reorganizations may be necessary after the acquisition to help maximize tax deductions.

The form chosen for an acquisition will generally determine its tax consequences, although the tax authorities have the power to question the form if they believe the substance is different. Whether the taxpayer enjoys the same advantage is uncertain, but generally thought to be unlikely.

Recent Developments

From July 2008, the transformation/reorganization of companies is governed by the Act on Transformation of Companies. The Act introduces new rules on mergers and for the first time deals with cross-border mergers. It allows cross-border mergers of limited liability companies, joint stock companies, co-operatives, and general and limited partnerships. However, only mergers of entities with the same legal form are permitted. Four basic types of reorganization are specified: merger, de-merger (including spin-off), transfer of assets to the shareholder, and change of legal form. The act also governs accounting requirements for such transactions.

A participation exemption for capital gains was introduced in 2008. Initially this only applied to domestic

transactions, but from 1 January 2009 it was extended to cover many cross-border transactions. At the same time, however, the tax base was extended to include all gains on shares held by non-resident sellers.

In 2008 VAT grouping was introduced. The VAT group is considered to be a separate VAT payer and supplies carried out within the VAT group are not subject to VAT.

Asset Purchase or Share Purchase

There are two basic acquisition methods – asset deal and share deal.

Purchase of Assets

The main tax effect of an asset deal is that the buyer has full tax basis in the assets acquired and the seller is subject to tax on any gain.

An asset deal may take one of two forms:

- purchase of an enterprise or part of an enterprise (an activity capable of being operated as a separate business); or
- purchase of individual assets.

The main difference is that, in a purchase of an enterprise, the buyer takes over all the assets and liabilities of the seller, both disclosed and undisclosed. It is generally considered that tax liabilities do not transfer on a sale.

For the seller who realizes a gain, it is of little significance whether the sale is of assets or of an enterprise, since the gain in both cases will be taxable at 19 percent (corporate income tax was reduced from 20 percent in 2010) and 15 percent (personal income tax). However, losses on the sale of some assets (such as land) are not tax deductible.

Purchase Price

The buyer and the seller can apportion the price between individual assets, and it is unlikely that the tax authorities will question this as long as the buyer and seller are not related.

Goodwill

In the case of a purchase of an enterprise, it is possible to carry out a valuation of the assets acquired that is valid for the tax purposes of the buyer. Any part of the purchase price not attributed to the individual assets in the valuation is treated as goodwill, which can be depreciated for tax purposes over 15 years (five years for accounting purposes). When no valuation is carried out, any difference between the price and the book value of the assets is classified as a valuation difference, which is depreciated for both tax and accounting purposes over 15 years.

No goodwill or valuation differences can arise on a purchase of individual assets. In this case, the whole purchase price is allocated between the individual assets.

The accounting and tax rules on goodwill also apply to negative goodwill, that is, the situation where the price is lower than the value of the assets. Such cases are not uncommon in the Czech Republic, possibly because assets were originally over-valued during the privatization process. This means that where the parties do not agree on a detailed allocation of the purchase price, there is a risk that the buyer will have taxable income. The income is taxed over 15 years.

Depreciation

Generally, the buyer re-starts tax depreciation of the acquired assets (that is, does not continue the depreciation policies of the seller) in both the case of a sale of individual assets and of sale of an enterprise. The buyer starts depreciating the new depreciation base which is, generally, the purchase price, plus related acquisition costs.

Tax Attributes

Tax losses carried forward cannot be transferred in the case of an asset acquisition, they remain with the seller. Tax liabilities also remain with the seller.

Value-Added Tax (VAT)

The Czech Republic levies VAT at 10 percent and 20 percent. Most goods and services are subject to the standard rate of 20 percent.

A sale of assets is usually a taxable supply for VAT purposes, although some items are exempt from VAT or outside its scope (in which case a VAT clawback from input VAT previously claimed on the sold assets might arise). The sale of an enterprise is not a supply for VAT

purposes; the seller remains entitled to a credit for any related input VAT.

In the case of a purchase of the whole or part of an enterprise, the acquirer may be obliged to repay input VAT claimed by the original owner on the purchase of fixed assets, if the assets are used for VAT-exempt supplies in the future. The clawback period is five years.

The tax authorities do not recognize goodwill for VAT purposes. This means that where there is goodwill on a sale of assets subject to VAT (that is, not an exempt sale of an enterprise) the goodwill element must be attributed to the other assets transferred, and VAT imposed according to the categories of the assets concerned.

Transfer Taxes

There are no stamp or capital duties in the Czech Republic, and the only transfer tax that may be encountered in the course of an acquisition is real estate transfer tax, currently levied at 3 percent on the higher of the purchase price or the fair value of real estate transferred. This is an obligation of the seller, but the liability passes to the buyer if the seller defaults.

Purchase of Shares

In a share deal, there is no step-up for the buyer or the target in relation to any premium over the accounts/tax value of the target's assets. The buyer inherits undisclosed liabilities, including the tax liabilities of the target company.

The tax treatment of the sale depends on the status of the seller. In the case of a corporation, any gain on the sale is subject to corporate income tax of 19 percent as normal income unless the participation exemption applies. Gains on the sale of shares in a Czech subsidiary (10 percent holding for at least 12 months) are tax exempt for Czech, EU, Icelandic, and Norwegian resident corporate sellers. Losses on disposal are not deductible, except in the case of shares in a joint stock company (a.s.) or European company (SE) held for trading purposes. The exemption also applies to sales of some non-Czech subsidiaries. A minimum of 10 percent should be held for at least 12 months, and the subsidiary must be tax-resident in either the European Union or a country with which the Czech Republic has concluded a double tax treaty and which has a corporate tax rate of at least 12 percent.

In the case of an individual who has not treated the shares as a business asset, a gain on the sale of shares in an a.s. or SE is exempt from tax if the shares have

been held for more than six months, provided that the maximum shareholding did not exceed 5 percent of the registered capital or voting rights in the 24 months prior to the sale. If these conditions are not fulfilled, the gain is taxable unless the shares have been held for five years. A gain on the sale of an interest in a limited liability company (s.r.o.) is exempt from tax if the interest has been held for more than five years.

Where the buyer is a Czech tax-resident and the seller is not based in the European Union or European Economic Area, the buyer is required to withhold security tax as an advance against tax payable unless treaty protection is available. The rates are 1 percent for income from the sale of investment instruments/shares in an a.s. and 10 percent for income from the sale of interest in an s.r.o.

The sale of shares in an a.s. is exempt from VAT with no right to deduct input VAT. The VAT treatment of the sale of shares in an s.r.o. has been unclear, although it is usually considered that it is not subject to VAT and the seller has the right to deduct input VAT (such as on the services related to the sale). From 2010 all share sales are VAT exempt with no right to recover input VAT.

Tax Indemnities and Warranties

In a share acquisition, the buyer is taking over the target company together with all related liabilities, including tax liabilities. The buyer will, therefore, normally require more extensive indemnities and warranties than in the case of an asset acquisition, where tax liabilities do not transfer.

Tax Losses

Tax losses incurred up to 31 December 2003 may be carried forward for up to seven years. Those incurred after 1 January 2004 may be carried forward for five years. The tax law prevents the use of tax losses where there is a substantial change in the persons directly participating in the company's equity or management and less than 80 percent of the company's income in the year in which the loss is to be used is derived from the same activities as in the year when the loss arose. A change in the ownership of more than 25 percent of the registered capital or voting rights is always a substantial change. A taxpayer can apply to the authorities to confirm the availability of the carried-forward losses after the end of the taxable period in which the losses are to be used.

Crystallization of Tax Charges

There are usually no exit charges for leaving the group. The main exceptions are:

- withholding tax on dividends when the 12-month minimum holding period has not been met;
- withholding tax on interest when the 24-month minimum holding period has not been met; and
- real estate transfer tax triggered by a sale of shares acquired in exchange for a contribution of real estate within 5 years.

Pre-Sale Dividend

Pre-sale dividends are rare in practice, particularly as the Czech commercial law prohibits the interim payment of dividends. If there is a qualifying corporate shareholding, both dividends and capital gains are exempt, i.e. the tax treatment does not differ. If the dividends are paid to an individual, there is no exemption from taxation; that is, the dividends are always taxable while the gain can be exempt. Therefore, dividends are not usually tax efficient.

Transfer Taxes

There are no stamp or capital duties in the Czech Republic, but administration fees are payable on certain services rendered by various government bodies.

Tax Clearances

Most transactions and reliefs are not subject to tax clearances. Some formalities need to be fulfilled for corporate reorganizations.

In a share deal the seller is usually required to provide confirmation from the tax authorities that there are no tax arrears, although this does not preclude additional tax being assessed in the future.

A taxpayer can ask the tax authorities for a tax ruling relating to certain issues in advance (such as, use of tax losses, transfer pricing).

Choice of Acquisition Vehicle

There are several potential acquisition vehicles available to a foreign buyer and tax factors often influence the choice. There is no capital duty on the introduction of new capital to a Czech company, including a Czech registered SE or branch.

Local Holding Company

A Czech holding company is usually used as an acquisition vehicle when the foreign buyer wishes to

ensure that the taxable profits of the Czech target company can be offset against tax deductible interest expenses from an acquisition loan. The company which makes the acquisition merges with the target to have the taxable income of the target and the expenses related to the acquisition in one entity. Interest on acquisition loans is generally non-deductible, but if the target company is merged with the acquirer within one year, the interest expenses usually can be tax deductible. A decision to establish a Czech holding company may be also made for business reasons.

The legal forms most commonly used are limited liability companies and joint stock companies. The reason is that only these two legal forms allow the exemption from taxation of profit distributions under the Parent-Subsidiary directive. They also give limited liability to the shareholders. An SE could also function as the acquisition vehicle, but is more administratively burdensome.

Foreign Parent Company

The foreign buyer might choose to acquire the Czech target company itself, because it wishes to offset the interest on an acquisition loan against its own profits, which is possible in certain tax jurisdictions. As noted above, cross-border mergers of Czech companies are now allowed, but much more administratively demanding than local mergers of two Czech companies.

Non-Resident Intermediate Holding Company

A non-resident intermediate holding company is usually used when the relevant double tax treaty provides for a more favorable tax treatment of capital gains or dividends. EU holding companies will usually qualify for the participation exemption.

Local Branch

Under some circumstances a foreign parent company may structure its investments through a Czech branch. Czech commercial law would also require a branch to be registered if the foreign parent company systematically performs a business activity in the Czech Republic and has no subsidiary here. Generally, the tax status of a Czech branch does not differ from the tax status of a local company (the same rules for the tax base calculation, the same tax rate). However, there are some differences' e.g. the distribution of profit by a Czech branch is not regarded as a dividend. There is no branch profits tax.

Joint Ventures

A joint venture can be either corporate (with the joint venture partners holding shares in a Czech company) or

unincorporated (usually a partnership), which is (at least partially) tax-transparent.

Choice of Acquisition Funding

A buyer using a Czech entity to carry out an acquisition can finance the acquisition vehicle by debt, equity, or a combination of both.

Debt

The principal advantage of financing an acquisition by debt is the potential interest deductibility, as opposed to the payment of dividends that are not tax-deductible. The related financial expenses are usually deductible. Moreover, debt financing has the advantage of avoiding a dilution of equity. The costs of debt financing are, therefore, lower than the costs of equity.

It is important to choose an acquisition vehicle that allows the offsetting of interest expenses against taxable income. According to the Czech tax law, interest on loans taken out less than six months before the acquisition of a subsidiary is generally non-deductible (see later in the chapter). The tax deductibility of interest on loans provided by a related party can also be limited by the Czech thin-capitalization and transfer pricing rules.

Deductibility of Interest

Expenses paid or payable for the purpose of earning taxable income are generally tax deductible. Therefore, interest should in such circumstances be deductible subject to transfer pricing and thin-capitalization considerations. This general rule is subject to some exceptions:

- Interest paid by a Czech company is generally deductible on an accruals basis. However, if it is payable to an individual who does not keep double-entry books, it can only be deducted on a paid basis.
- Interest should be incurred to earn taxable income. Dividends and other income subject to withholding tax as a final tax are not taxable income for this purpose.
- Expenses paid in connection with a holding in a subsidiary company are generally non-deductible. The law includes a rebuttable presumption that interest on loans taken out less than six months before the acquisition is paid in connection with the holding in the subsidiary. There is also a rebuttable presumption that 5 percent of distributions received from a subsidiary are disallowable indirect costs of holding the investment. Such costs can be added to

the base cost of the asset for the purpose of calculating gains on future disposals. The definition of 'subsidiary' for this purpose is drawn from the legislation enacting the EU Parent/Subsidiary Directive, which includes a requirement for the parent to hold 10 percent of the shares for at least 12 months.

A merger of the holding company with the target can mitigate the last two of these concerns. Alternatively, it is possible to convert the target into a tax-transparent entity, so that the buyer's interest expense becomes deductible against its share of the profits of the target's business.

The Czech thin-capitalization provisions restrict the deductibility of interest where the borrower has insufficient equity. Until the end of 2007 the provisions only applied to related-party loans and restricted deductibility of interest if the debt-to-equity ratio exceeded 4:1. The law has changed several times since then, but the current provisions are similar to those in force earlier.

The rules can be summarized as follows:

- financial expenses arising from loans and credits received from related parties in excess of four times (six times for banks and insurance companies) the borrower's equity are not tax deductible;
- interest on loans and credits received from unrelated parties, or those secured by a related party, is fully deductible on general principles, except for interest on back-to-back loans (that is, where a related party provides a loan, a credit, or a deposit to an unrelated party, which then provides the funds to the borrower), which is treated as interest on related party debt; and
- where the interest or other revenue is derived from the borrower's profit, all financial expenses on the loans and credits received are not tax-deductible.

Notwithstanding the thin-capitalization provisions, financial expenses incurred that directly relate to taxable income (such as interest income) can be deducted up to the amount of that income.

The new rules can be applied to taxation periods (or periods for which a tax return is filed) starting in 2008. Interest paid based on loan contracts concluded before 1 January 2008 does not fall within the ambit of the new regulation for tax periods commencing in 2008 and 2009. Interest on debts incurred for the purposes of the

purchase of business assets would normally be tax deductible.

Withholding Tax on Debt and Methods to Reduce or Eliminate

The Czech Republic levies withholding tax (WHT) of 15 percent on interest payable to non-resident lenders. This is usually, but not invariably, reduced by double-taxation agreement to 0 percent. Interest paid to certain associated companies that are resident in the European Union is free of withholding tax under the EU Interest and Royalties Directive, provided the recipient is the beneficial owner of the interest and the entitlement to the exemption is confirmed by the tax authorities.

The Czech tax law allows interest to be re-classified as a dividend if it is non-deductible due to a breach of the transfer pricing or thin-capitalization rules. This can have adverse withholding tax consequences. This reclassification does not apply to EU or EEA lenders.

Interest paid by a Czech-resident company to a Czech-resident lender is not subject to WHT.

Checklist for Debt Funding

The following factors should be taken into account when debt funding is being considered:

- deductibility of interest connected with an acquisition of a company;
- thin-capitalization rules, if a loan is granted by a related party;
- transfer pricing – interest on a related-party loan should be set at arm's length;
- effective tax rate for the lender; and
- reduction in or exemption from WHT.

Equity

A buyer can use equity to fund the acquisition rather than debt. The main way to increase equity is by issuing new shares.

The main disadvantage of equity financing is dilution of the shareholders' ownership (in the case of an increase of equity made disproportionately to the voting rights of each shareholder) and the fact that dividends cannot be deducted from the tax base. Equity financing is generally considered a less preferable option than debt financing.

However, in certain situations equity financing might be preferable, especially in the following situations:

- the target company is a loss making company;
- the debt-to-equity ratio is too high and exceeds the thin-capitalization limits;
- a higher effective tax rate in the home country of the lender; or
- non-tax related business reasons, such as credibility of a company or regulatory restrictions.

Tax-Free Corporate Reorganizations

There are no comprehensive tax rules on corporate reorganizations. The rules that exist (the enactment of the EU Merger Directive and the EU Directive on Cross-border Mergers) are intended generally to allow reorganizations to take place on a tax-neutral basis. The tax authorities have the power to challenge the intended tax effects of a transaction on the basis that the substance of the transaction is other than the form, but in practice, this is rare. Typical transactions are described below.

Contribution In-Kind

The Income Tax Act (ITA), section 30(10) requires the recipient of a contribution in-kind to the capital of a company to continue the tax depreciation policies of the person making the contribution. In the case of cross-border contributions to a Czech company, the recipient must continue tax depreciation of the contributed assets based on the original purchase price of the contributed asset calculated in Czech crowns on the date of contribution and using the Czech tax rules. Tax depreciation on the contributed assets can, however, can only be claimed up to the difference between the original purchase price and the tax depreciation already claimed by the contributor. Except where the EU Merger Directive applies (section 23a ITA), the tax law is silent as to the treatment of the person making the contribution; however, according to the accounting rules, the contributor does not realize gain in such a case, but records the shares received at the net book value of the asset contributed. The Commercial Code does not provide for the contribution of assets in exchange for shares plus cash and, in practice, such transactions do not occur.

Section 23a ITA does not refer to contributions of assets, but only to a contribution of an enterprise or part of an enterprise as defined for the purposes of the Commercial Code (that is, an activity that can be operated as a separate business, as required by the Merger Directive, and including all liabilities, both disclosed and undisclosed) involving Czech and/or EU

resident companies (but excluding both types of Czech partnership). The legislation implies that transactions that do not meet its conditions (must involve Czech or EU resident companies and must involve an enterprise, not merely assets) may be taxable. However, discussions with the Finance Ministry suggest that it is not the intention of the law to tax transactions that do not fall within the terms of section 23a ITA.

The law states explicitly that the person making the contribution does not realize a taxable gain, and permits the transfer of reserves and tax losses that have arisen after EU accession (1 May 2004). Furthermore, it provides that the person receiving shares in exchange for a qualifying contribution should record these shares at market value for tax purposes. This does not, however, apply if the contributor transfers the shares within one year. Moreover, tax attributes cannot be transferred if the main or one of the reasons for the contribution is to reduce or avoid the tax liability.

A contribution of assets which does not qualify as an enterprise is regarded as taxable supply for VAT purposes if the contributor claimed an input VAT deduction when the assets were purchased. The contributor and the acquirer are jointly liable for the VAT. The contribution of some asset classes can be exempt from VAT (such as real estate) if certain conditions are met.

A contribution of an enterprise or part of an enterprise is not a VATable supply. Nevertheless, the company which receives an enterprise or part of an enterprise may be obliged to repay input VAT claimed originally by the contributor, if the fixed assets are later used for VAT-exempt supplies. The clawback period is five years.

Contributions of real estate to the registered capital of a company are exempt from real estate transfer tax if the contributor retains an interest in the recipient for five years. There are no stamp or capital duties.

Merger

In a merger, the predecessor company ceases to exist without going into liquidation, and all its assets and liabilities pass to the successor. There are no detailed tax rules on mergers except for the cases dealt with by section 23c ITA (which implements the EC Merger Directive). In general, however, a merger is tax neutral. The transfer of fixed assets is at the tax residual value, and any goodwill arising cannot be depreciated for tax purposes. The parties to the merger can agree that reserves and provisions of the predecessor will be transferred to the successor. In the absence of such an

agreement, they must be written back in the accounts of the predecessor except in the following cases:

- the transfer of all assets and liabilities of the dissolving company to an existing company in exchange for the issue of shares and, possibly, a cash payment by the successor to the shareholders of the dissolving company;
- the transfer of all assets and liabilities of the dissolving company to a newly formed company in exchange for the issue of shares and, possibly, a cash payment by the successor company to the shareholders of the dissolving company; and
- the transfer of all assets and liabilities of the dissolving company to a company which is its 100-percent shareholder.

For qualifying mergers:

- no gain or loss is realized by the shareholders of the dissolving company on their disposal of its shares, except to the extent that they receive cash;
- the value of the shares received is equal to the value of the shares in the company which ceases to exist (that is, no step-up in the value of the shares);
- tax depreciation policies which ceases to exist are continued by the successor(s);
- tax losses arising after EU accession are transferred, provided that tax avoidance is not a main purpose of the transaction; and
- reserves and provisions are automatically transferred subject to the same tax avoidance restriction as on the transfer of losses.

The companies concerned have to be residents of the Czech Republic or another EU Member State. Based on the EU Directive on Cross-Border Mergers, it is possible to merge a Czech company with any company registered in an EU Member State.

For accounting and income tax purposes (but not legally, or for VAT), it is possible for the effective date of a merger to be up to 12 months earlier than the date on which the application for registration of the merger is filed with the commercial court.

There are no real estate transfer tax, VAT, or stamp/capital duties. Nevertheless, the successor may be obliged to repay input VAT claimed originally by the predecessor, if the fixed assets acquired are later used

for VAT-exempt supplies. The clawback period is five years.

De-Merger

Under the Act on Transformation of Companies, in a de-merger the predecessor company ceases to exist and its assets are transferred to two or more newly incorporated successor companies, which issue shares to the shareholders of the predecessor. Again, the ITA is generally silent on the effects, subject to the Merger Directive legislation (section 23c ITA). The same rules apply as in the case of a merger (with the necessary changes), that is, tax neutrality with regard to transfers of assets, no tax deduction for depreciation of goodwill, transfer of post 1 May 2004 tax losses, and possible transfer of reserves and provisions by agreement.

The successors may be obliged to repay input VAT claimed originally by the predecessor, if the fixed assets are later used for VAT-exempt supplies. The clawback period is five years.

Spin-Off

A spin-off is an alternative de-merger. In a spin-off the de-merged company does not cease to exist, but the spun-off part is transferred to an existing or newly incorporated company. The spin-off is tax neutral. The transfer of tax provisions, reserves, and tax losses to the successor is possible to the extent that the transaction can be commercially justified.

There are no real estate transfer tax, VAT, or stamp/capital duties. Nevertheless, the successor may be obliged to repay input VAT claimed originally by the de-merged company, if later used for VAT-exempt supplies. The clawback period is five years.

Tax Losses and Reorganizations

When losses are transferred on a merger, de-merger, or spin-off, they can be used only against the profits derived from the activity transferred in the merger, de-merger, or spin-off. Similarly, where the surviving company has losses, these can be used only against the profits generated by its activity before the merger or spin-off. Where an activity is transferred through a contribution of an enterprise, the losses transferred can only be used against the profits of the activity transferred, but there is no restriction on the use of the losses by the transferee.

Hybrids

A buyer can also combine both debt and equity to achieve the desirable debt-to-equity ratio.

Generally, the Czech law does not deal with hybrid instruments and the tax treatment tends to follow the legal form (subject to the substance over form rule).

Discounted Securities

The tax treatment of securities issued at a discount to third parties generally follows the accounting treatment. The discounted amount should be written off over the period until maturity. Under domestic legislation interest paid to non-residents and the accrued discount are both subject to 15 percent WHT, subject to reductions under a relevant double tax treaty or the EU Interest and Royalty Directive. The law is not clear as to whether the thin-capitalization provisions apply to discounts.

Deferred Settlement

An acquisition often involves an element of deferred consideration, the amount of which can only be determined at a later date on the basis of the post-acquisition performance of the business. The right to receive an unknown/conditional future amount should not be recognized for either tax or accounting purposes applying the prudence principle. If the receipt of an agreed amount is simply deferred without conditions, it is recognized as taxable income at the time of the sale.

Other Considerations

Both the substance over form rule and the abuse of law concept need to be taken into account when structuring transactions. The tax authorities have the power to ignore the strict legal form and adjust the tax effects of any transaction based on these concepts. The abuse of law doctrine applies to situations in which a person exercises his or her rights to the detriment of others or society in general. The Czech courts should not provide legal protection to such an exercise of rights which is, at the same time, an abuse of those concepts.

For example, if a merger of holding company with its target company takes place, the participating companies should document and justify proper business reasons for the transaction, to prove that the transaction is not designed solely to obtain tax benefits or to avoid taxation.

Concerns of the Seller

As the Czech tax law provides for an exemption from the taxation of capital gains for many sellers, this is usually the main area of concern.

Company Law and Accounting

The Czech company law provides for the following legal entities:

- General partnership (v.o.s.)
- Limited partnership (k.s.)
- European company (SE)
- Limited liability company (s.r.o.)
- Joint stock company (a.s.)

The shareholders of an s.r.o. are liable for the unpaid liabilities of the company up to the total amount of unpaid contributions to the registered capital. The shareholders of an a.s. or an SE (if governed by Czech law) are not liable for the unpaid obligations of the company. The SE has several tax advantages, but as the process of establishment is administratively demanding, it is not often used.

A general partnership is a tax-transparent entity. A limited partnership is partly tax-transparent (for the income apportioned to the general partner). The main disadvantage of these two legal forms is the unlimited liability of the general partners. The partners in a v.o.s. are liable for all unpaid liabilities of the partnership. In the case of a k.s., a general partner is fully liable for unpaid liabilities, while a limited partner is only liable up to the amount of unpaid contributions to capital.

Generally, the Czech accounting rules are governed by the Act on Accounting. Further detailed guidance is provided in the Decrees on Double-Entry Accounting and Czech National Accounting standards. All businesses registered in the Czech Commercial Register are obliged to use double-entry bookkeeping. The accounting period is generally defined as a period of twelve consecutive months. The accounting unit can either use a calendar year or specify a business year end other than 31 December. Statutory financial statements consist of a balance sheet, a profit and loss account, and notes. The Act on Accounting states that certain business units are subject to mandatory statutory audits and must prepare separate annual reports. Additional filings may need to be made in the event of a reorganization.

Group Relief/Consolidation

There is no tax consolidation for Czech corporate tax purposes. This means that the use of a highly leveraged Czech holding company to acquire a target is tax-ineffective, unless followed by a merger or a transformation of the target to a partnership.

Transfer Pricing

Generally, prices between related parties should be set at arm's length. The Czech Income Taxes Act has a very

wide definition of related parties. While it does not provide for mandatory transfer pricing documentation, guidelines have been issued which describe standards that the tax authorities would expect to be followed. A taxpayer can ask the tax authorities for a tax ruling relating to the arm's length price in advance.

Dual Residency

The Czech Income Taxes Act defines a resident company as one that has its seat in the Czech Republic, or whose place of effective management is in the Czech Republic. It is considered that the seat cannot be transferred outside the Czech Republic (except for an SE). Czech-resident foreign companies are very rare. A pure change of the place of management of a Czech company outside the Czech Republic should not affect its tax-residency in the Czech Republic.

Foreign Investments of a Local Target Company

There is no controlled foreign companies (CFC) legislation in the Czech Republic. Nevertheless, as noted above, Czech tax law contains a substance-over-form rule and an abuse of law concept, which should be considered.

Comparison of Asset and Share Purchases

Advantages of Asset Purchases

- The purchase price, including goodwill, can be depreciated for tax purposes.
- Interest payable on borrowings is generally deductible.
- Except in the case of a purchase of an enterprise, liabilities are not inherited (and even in that case, tax liabilities should be excluded).
- It is easier to acquire only part of a business.

Disadvantages of Asset Purchases

- Additional legal formalities apply in the areas of notification of suppliers, change of name, and employment law (although on a purchase of an enterprise, employment contracts transfer automatically).
- When only assets are purchased, the initial price will usually be higher.
- When the vendors are individuals, the existence of exemptions from tax for sales of companies will make this structure much less attractive.

- Tax losses are not acquired.
- Complications may result from rules on the allocation of the purchase price on the purchase of an enterprise.
- Possible real estate transfer tax liability for the vendor may affect the price.
- Possible VAT claw-backs, if the transaction is VAT exempt or if the business makes VAT exempt supplies in the future.

Advantages of Share Purchases

- Deal is attractive to vendors, especially if they are individuals or are exempt from corporate tax on any gains.
- It may be possible to use tax losses, subject to restrictions.
- Contracts with suppliers, employees, among others, will automatically pass.
- No real estate transfer tax or capital taxes.

Disadvantages of Share Purchases

- There is no tax deduction for the purchase price until shares are sold.
- Restrictions on interest deductibility may exist, unless a merger follows the acquisition.
- Buyer inherits all undisclosed liabilities of the target company, including tax liabilities.
- No step up on assets is possible.

Withholding Tax Rate Chart

The rate information and footnotes contained in this table are from the 2009 IBFD/KPMG Global Corporate Tax Handbook.

Country	Dividends		Interest ¹	Royalties
	Individuals, companies (%)	Qualifying Companies ² (%)		
Albania	15	5	5	10
Australia	15	5 ³	10	10
Austria	10	0 ⁵	0	0/5 ⁴
Azerbaijan	8	8	5/10 ⁶	10
Belarus	10	10	5	10
Belgium	15	5	0/10 ⁷	0/5 ⁸
Bosnia and Herzegovina ⁹	15	5	0	10
Brazil	15	15	-/10/15 ¹⁰	15/25 ¹¹
Bulgaria	10	10	10	10
Canada	15	5 ⁵	10	10
China (People's Rep.)	10	10	10	10
Croatia	5	5	0	10
Cyprus	5	0 ⁵	0	10/0 ⁴
Denmark	15	15	0	0/5 ⁴
Egypt	15	5	15	15
Estonia	15	5	10	10
Ethiopia	10	10	10	10
Finland	15	5	0	0/1/5/10 ¹²
France	10	0	0	0/5/10 ¹³
Georgia	10	5	8	0/5/10 ¹³
Germany	15	5	0	5
Greece	- ¹⁴	- ¹⁴	10	0/10 ⁴
Hungary	15	5	0	10
Iceland	15	5	0	10
India	10	10	10	10
Indonesia	15	10 ³	12.5	12.5
Ireland	15	5	0	10
Israel	15	5 ²⁴	10	5
Italy	15	15	0	0/5 ⁴
Japan	15	10	10	0/10 ⁴
Jordan	10	10	10	10
Kazakhstan	10	10	10	10
Korea (Dem. Rep.)	10	10	10	10
Korea (Rep.)	10	5	10	0/10 ⁴
Kuwait	5	0 ¹⁵	0	10
Latvia	15	5	10	10
Lebanon	5	5	0	5/10 ²⁵
Lithuania	15	5	10	10
Luxembourg ¹⁶	15	5	0	0/10 ⁴
Macedonia	15	5	0	10
Malaysia	10	10	12	12
Malta	5	5	0	5
Mexico	10	10	10	10
Moldova	15	5	5	10
Mongolia	10	10	10	10
Montenegro ¹⁷	10	10	10	5/10 ¹⁸
Morocco	10	10	10	10
Netherlands	10	0	0	5
New Zealand	15	15	10	10
Nigeria	15	12.5 ⁵	15	15
Norway	15	0 ⁵	0	0/5/10 ¹³
Philippines	15	10 ⁵	10	10/15 ¹⁹
Poland	10	5 ³	10	5

Country	Dividends		Interest ¹	Royalties
	Individuals, companies (%)	Qualifying Companies ² (%)		
Portugal	15	10	10	10
Romania	10	10	7	10
Russia	10	10	0	10
Serbia ¹⁷	10	10	10	5/10 ¹⁸
Singapore	5	5	0	10
Slovak Republic	15	5 ⁵	0	0/10 ⁴
Slovenia	15	5	5	10
South Africa	15	5	0	10
Spain	15	5	0	0/5 ¹⁹
Sri Lanka	15	15	10	0/10 ²⁰
Sweden	10	0	0	0/5 ²⁰
Switzerland	15	5	0	5/10 ²¹
Tajikistan	5	5	0/7 ⁶	10
Thailand	10	10	10/15 ²²	5/10/15 ²³
Tunisia	15	10	12	5/15 ⁴
Turkey	10	10	10	10
Ukraine	15	5	5	10
United Arab Emirates	5	0	0	10
United Kingdom	15	5	0	0/10 ⁴
United States	15	5 ⁵	0	0/10 ²⁰
Uzbekistan	10	10	0/5 ⁶	10
Venezuela	10	5 ²⁴	10	12
Vietnam	10	10	10	10

Notes

- Many treaties provide for an exemption for certain types of interest, such as interest paid to the state, local authorities, the central bank, export credit institutions, or in relation to sales on credit. Such exemptions are not considered in this column.
- Unless otherwise indicated, the reduced treaty rates given in this column apply if the holding is at least 25 percent of the capital or of the voting power, as the case may be.
- A minimum holding of 20 percent is required.
- The lower rate applies to copyright royalties, including films, etc.
- A minimum holding of 10 percent is required.
- The lower rate applies, inter alia, to interest on bank loans.
- The lower rate applies, inter alia, to interest on bank loans and deposits.
- The zero rate applies to copyright royalties, including films, etc. (the rate of 10 percent was reduced to 0 percent from 1 January 2004 following the conclusion of the treaty between the Czech Republic and the Slovak Republic – most-favored nation treatment); the 5-percent rate applies to industrial royalties and know-how (the treaty rate of 10 percent was reduced to 5 percent from 1 January 2008 following the conclusion of the treaty between the Czech Republic and Austria – most-favored nation treatment); the 5-percent rate under the Belgium-Czech Republic treaty continues to apply to equipment rentals.
- The treaty concluded between the former Czechoslovakia and the former Yugoslavia.
- The domestic rate applies to interest paid by public bodies (under the treaty such interest is taxable only in the source state and there is no reduction). The 10-percent rate applies in respect of loans granted by banks for at least 10 years, subject to conditions.
- The 25-percent rate applies to trademarks.
- The 1-percent rate applies to royalties paid for finance leases of equipment; the 5-percent rate applies to royalties paid for the use of computer software and operational leases of equipment; the 10-percent rate applies to industrial royalties in general.
- The zero rate applies to copyright royalties, excluding computer software, but including films, etc. The 5-percent rate applies to equipment rentals. The 10-percent rate applies to patents, trademarks, and know-how.
- The domestic rate applies; there is no reduction under the treaty.
- No withholding tax applies to dividends received by (i) a government or a governmental institution or (ii) a company which is controlled or in which at least 25 percent of the capital is held by a government or a governmental institution.
- The treaty does not apply to income paid to exempt Luxembourg holding companies.
- The treaty concluded between the Czech Republic and the former Serbia and Montenegro.
- The lower rate applies to copyright royalties, excluding computer software, but including films, etc.
- The lower rate applies to copyright royalties, excluding film royalties.
- The lower rate applies to copyright royalties, including films, etc.
- The rate is 5 percent as long as Switzerland does not levy withholding tax on royalties under its domestic law.
- The 10-percent rate only applies to interest received by financial institutions, including insurance companies. For other interest payments there is no limitation under the treaty; the domestic rate applies.
- The 5-percent rate applies to copyright royalties, excluding films, etc.; the 10-percent rate applies to royalties for patents, trademarks, design, and models, and secret formulae and processes.
- A minimum holding of 15 percent is required.
- The 5-percent rate applies to equipment rentals.

KPMG in Czech Republic

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> '8\$%\$?DA ; '7Yg_ÓfYdi V_]Užg"fc"žU'7nYVM FYdi V']W]a]HYX"JU VJ]JmVž'a dUbmUbX'U'a Ya VYf'Zfa 'cZH.Y?DA ; 'bYrk cf_'cZ]bXY! dYbXYbha Ya VYf'Zfa g'UZZ]UHYX'k]H. ?DA ; 'bHYfbU]cbU'7ccdYf! U]j Y'f? DA ; 'bHYfbU]cbU'žU'Gk]gg'Yb]m' 5" f[\fj fYgYfj YX"

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